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EBS/86/137

CONFIDENTIAL

June 27, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Chile - Staff Report for the 1986 Article IV Consultation and Review Under Extended Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Chile and a review under its extended arrangement, which will be brought to the agenda for discussion on a date to be announced. Draft decisions appear on pages 38-40.

Mr. Loser (ext. 8373) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 1986 Article IV Consultation and Review under the Extended Arrangement

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

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

Approved by E. Wiesner and Manuel Guitián

June 24, 1986

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I. Introduction

The 1986 Article IV consultation discussions with Chile 1/ and the review under the extended arrangement were conducted in Santiago during the period April 28 to May 16, 1986. The representatives of Chile in the discussions included the Ministers of Economy, Finance, Labor, Mining, and ODEPLAN; the President and Vice President of the Central Bank; the Superintendents of Banks and of Pension Plan Funds; the Budget Director; and senior officials of the Ministries of Economy, Finance, Agriculture, ODEPLAN, the Central Bank, Government agencies, and public enterprises. The staff mission consisted of Mr. C. Loser (Head), Ms. P. Brenner, Messrs. J. Jaramillo-Vallejo, J. Leimone, (all WHD), Mr. A. Petersen (ETR), and Mrs. Owen (Secretary-LEG). Mr. C. Lee, the Fund's resident representative in Chile, assisted the staff during the mission.

The previous Article IV consultation discussions with Chile were concluded by the Executive Board on July 15, 1985 (EBS/85/122, and Supps. 1, 2, and 3). At the time the Executive Board also approved in principle Chile's request for a three year extended arrangement for an amount of SDR 750 million, equivalent to 170 percent of quota. The extended arrangement became effective on August 15, 1985 (EBS/85/122, Sup. 4). A CFF purchase for SDR 70.6 million also was approved on July 15, 1985 (EBS/85/124). On November 7, 1985 the Executive Board granted a waiver for the nonobservance of the net international reserves target for end-September and the intention to increase travel allowances, which was postponed until December 1985. On February 28, 1986, the Executive Board completed the first review under the first year of the extended arrangement, including the specification of quantitative performance criteria for the period January 1 through June 30, 1986 (EBS/86/20).

During the recently completed discussions, the authorities and the staff reviewed the policy actions taken to date and the progress being made under the arrangement. Understandings were reached with respect to the policy intentions for the second year of the arrangement and with respect to the targets and ceilings for the remainder of 1986. These understandings are contained in the attached letter and economic policy memorandum from the Minister of Finance and the President of the Central Bank of Chile (Attachments I and II).

To date Chile has purchased SDR 250 million under the extended arrangement. Purchases under the arrangement are not to exceed the equivalent of SDR 250 million before July 15, 1986 and SDR 500 million before July 15, 1987. It is proposed that the phasing for the second year of the arrangement be as follows: purchases could not, without the consent of the Fund, exceed the equivalent of SDR 250 million until August 15, 1986, SDR 312.50 million until November 14, 1986, SDR 375

1/ Chile has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

million until February 13, 1987, and SDR 437.50 million until May 15, 1987.

As of May 31, 1986, the Fund's holdings of Chilean pesos amounted to SDR 1,509.1 million or 342.5 percent of Chile's quota of SDR 440.5 million, of which 74.6 percent corresponded to purchases under the CFF. With full use of the resources remaining under the extended arrangement the Fund's holdings of pesos by the end of the extended arrangement would be the equivalent of 339.5 percent of quota (Table 1). Additional information on Chile's relations with the Fund is presented in Appendix I.

II. Background, Performance under the Extended Arrangement, and Recent Economic Developments

1. Background

Chile's external adjustment effort experienced a setback in 1984 as domestic demand and imports expanded at a fast pace at a time when copper prices declined sharply and foreign interest rates rose substantially. The deterioration in Chile's external situation together with the country's very high debt service ratio necessitated an intensification of the adjustment effort. The authorities responded with an economic program for 1985-87 that was later supported by the extended arrangement now in effect and a Structural Adjustment Loan from the IBRD. 1/ Chile also completed a financing package for 1985-86 with international commercial banks and a restructuring arrangement with official creditors.

Major objectives of the economic program were to reduce the external current account deficit, achieve moderate export-oriented economic growth, and reduce inflation. The program for the first year aimed at lowering the current account deficit from US$2.1 billion in 1984 to US$1.3 billion in 1985, achieving overall balance of payments equilibrium, and holding the rate of increase in prices to 25 percent. Further reductions in both the external current account deficit and the rate of inflation were targeted for 1986-87, along with a small overall balance of payments surplus. These objectives were to be achieved through tight demand management and the pursuit of market-oriented policies to improve resource allocation, and to promote savings, investment, exports and efficient import substitution.

At the time of the last Article IV consultation, Executive Directors welcomed the policy intentions of the authorities to reduce Chile's external imbalances and strengthen economic growth. Directors reviewed the adjustment effort undertaken in 1982-83 and expressed regret at the slippages that had occurred under the program in 1984.

1/ Appendix II summarizes the status of World Bank operations in Chile.

Table 1. Chile: Projected Fund Position, May 1986-July 1988 1/

	Operations During						
	First Year of Extended Fund Facility		Second Year				Third Year
	Outstanding May 31, 1986	June-July 1986	Aug. 1986-Oct. 1986	Nov. 1986-Jan. 1987	Feb. 1987-Apr. 1987	May 1987-July 1987	Aug. 1987-July 1988
	(In millions of SDRs)						
Transactions under tranche policies (net) 2/		-15.3	52.3	41.1	35.8	34.4	96.4
Purchases		--	62.5	62.5	62.5	62.5	250.0
Ordinary resources		--	31.2	31.2	31.2	31.2	125.0
Enlarged access resources		--	31.2	31.2	31.2	31.2	125.0
Repurchases		15.3	10.2	21.4	26.7	28.1	153.6
Ordinary resources		10.2	10.2	16.3	19.4	19.4	106.1
Enlarged access resources		5.1	--	5.1	7.4	8.8	47.4
Transactions under special facilities (net) 3/		-36.9	-36.9	-36.9	-36.9	-36.9	-73.8
Purchases		--	--	--	--	--	--
Repurchases		36.9	36.9	36.9	36.9	36.9	73.8
Total Fund credit outstanding (end-of-period)	1,068.6	1,016.4	1,031.8	1,036.0	1,034.9	1,032.5	1,055.2
Under tranche policies 2/	739.8	724.6	776.9	818.0	853.8	888.2	984.6
Special facilities 3/	328.7	291.8	254.9	218.0	181.1	144.2	70.6
	(As percent of quota)						
Total Fund credit outstanding (end-of-period)	242.6	230.7	234.2	235.2	234.9	234.4	239.5
Under tranche policies 2/	168.0	164.5	176.4	185.7	193.8	201.6	223.5
Special facilities 3/	74.6	66.2	57.9	49.5	41.1	32.8	16.0

Source: Fund staff estimates.

1/ Parts may not add to totals due to rounding.
2/ Ordinary and enlarged access resources.
3/ Compensatory financing facility.

Directors stressed the need for a major adjustment effort to be pursued persistently over the medium term through a major and durable increase in both private and public sector savings. Directors noted that while fiscal policy had been managed with prudence during most of 1984, it had eased substantially late in that year; the easing had been untimely as it led to a severe tightening of credit in circumstances under which the Central Bank sought to control the monetary impact of the devaluation.

Directors welcomed the decision to tighten financial policies and to adjust the exchange rate in 1985. Directors also noted the intention to eliminate the overall deficit of nonfinancial public sector within the period of the arrangement. Directors supported the reliance on market oriented-price policies in guiding resource allocation and endorsed the recent decision to reduce central bank subsidies. They noted that in Chile's circumstances there was little margin for slippage and that the authorities had to stand ready to implement additional measures if needed. Directors welcomed the support of the World Bank of Chile's program and the cooperation of commercial banks with regard to external financing. Finally, they urged the authorities to eliminate existing restrictive and multiple currency practices.

2. Performance under the extended arrangement

Except as noted below, Chile has observed the targets and objectives of the program and has effected all purchases available to date. Chile observed all the indicative limits and targets for dates preceding the approval of the extended arrangement as well as the quantitative performance criteria for August 1985. Also, as of the end of September 1985, Chile had observed all quantitative ceilings and targets, except for the target on net international reserves (Statistical Appendix Table 11), which was not met because of a delay in the disbursement of the new money facility from commercial banks. The delay in the loan disbursement also led the authorities to postpone until December 1985 the increase in travel allowances that had been scheduled to take place by the end of September. To effect the purchase scheduled for November, 1985, the authorities requested a waiver of the nonobservance of these two performance criteria; the waiver was approved by the Executive Board on November 7, 1985. In December commercial banks disbursed the first and second tranches of the new money facility and the authorities approved the increase in travel allowances. Subsequently, Chile observed all the quantitative performance criteria for December 31, 1985 (Table 2).

During the first quarter of 1986, Chile met all quantitative performance criteria and on May 15 it purchased SDR 62.5 million. All the disbursements by commercial banks scheduled to date have been made.

Table 2. Chile: Quantitative Criteria for Period Through December 31, 1986 and March 1986 Performance under the Economic Program

	Program Base December 31 1985	Limits and Targets for 1986 Jan. 1- Mar. 31	Apr. 1- June 30	July 1- Sept. 30	Oct. 1- Dec. 31
	(In billions of Chilean pesos)				
Net domestic assets of the Central Bank 1/2/3/					
Limit	545.9	615.5	636.0	694.0	730.0
Actual	...	592.7	...	...	...
Margin	...	22.8	...	...	...
Cumulative overall deficit of the nonfinancial public sector 2/5/					
Limit	...	23.2	44.3	59.3	71.8
Actual	...	14.2	...	...	...
Margin	...	9.0	...	...	...
	(In millions of U.S. dollars)				
Net international reserves of the Central Bank 4/5/6/					
Limit	1,080.2	894.0	1,060.0	943.0	1,130.0
Actual	...	985.6	...	...	...
Deviation	...	91.6	...	...	...
Contracting and guaranteeing of external debt by the public sector 7/					
Limit	...	500.0	500.0	500.0	500.0
Actual	...	8.0	...	...	...
Margin	...	492.0	...	...	...
Of which: debt with maturity of more than one year and less than five years	...	200.0	200.0	200.0	200.0
Subceiling	...	200.0	...	...	...
Actual	...	6.0	...	...	...
Margin	...	194.0	...	...	...
Rescheduling of external debt	...	170.0	170.0	170.0	170.0
Ceiling	...	170.0	...	...	...
Actual	...	14.0	...	...	...
Margin	...	156.0	...	...	...
Stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado	878.3	960.0	960.0-940.0 8/	1,010.0	1,010.0-990.0 9/
Limit	...	960.0	...	...	...
Actual	...	877.0	...	...	...
Margin	...	83.0	...	...	...

Source: Memorandum on the Economic Policies 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 (limits) will be adjusted downward for any cumulative increase in deposits in the copper income stabilization Fund (Fondo de Compensación del Cobre), and upward for any cumulative decrease in deposits in the copper stabilization Fund.

3/ These ceilings will be adjusted for revisions in the base data for December 31, 1985.

4/ These targets will be adjusted for any revisions in the base data for December 31, 1985.

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

6/ This target will be adjusted upward for any cumulative increase in deposits in the copper income stabilization fund and downward for any cumulative decrease in deposits in the copper stabilization fund.

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

8/ Lower figure of US$940 million refers to limit for June 30, 1986.

9/ Lower figure of US$990 million refers to limit for December 31, 1986.

3. Recent economic developments

a. Developments in 1985

In 1985 Chile made considerable progress toward achieving the objectives of the economic program, assisted by a strong performance of domestic savings, gross capital formation, and export volumes. The external current account deficit was in line with program projections and the overall balance of payments recorded a small surplus of US$4 million; the program had envisaged no change in net reserves. The annual rate of inflation, at 26.4 percent, was close to the program target of 25 percent. Real GDP grew by 2.4 percent from 1984 to 1985 (Table 3 and Appendix III). 1/

The strong performance of the external sector was the main factor explaining the growth in GDP in 1985, with exports of goods and services expanding by the equivalent of 4.3 percent of GDP, reflecting to a significant extent the effects of the adjustment effort. Real domestic expenditure, which had risen by 8.4 percent in 1984, declined by 1.9 percent in 1985, with consumption declining by around 1 percent in real terms. Total investment remained stable as a proportion of GDP, as fixed capital formation rose by 14.2 percent in real terms and stocks declined. National savings rose by 2.6 percentage points of GDP, reflecting an improvement in public sector savings (Table 4).

Real wages rose by some 2 percent from December 1984 to December 1985 after a decline of some 4 percent during 1984. Employment, including participants in Government special work programs, rose by some 8 percent through the end of the year. As a consequence, the rate of unemployment declined from 14 percent in the fourth quarter of 1984 to 12 percent in the fourth quarter of 1985.

A key element in last year's adjustment was the improvement of the public finances. The overall deficit of the nonfinancial public sector declined from 4.3 percent of GDP in 1984 to 2.6 percent in 1985, some 0.4 percentage points of GDP below the program limit 2/ (Table 5 and Chart 1). This outturn reflected the increase in public sector saving (from 0.6 percent of GDP in 1984 to 3.8 percent in 1985) that stemmed from increased operating surpluses of public sector enterprises and continued restraint on general government current expenditures.

1/ The main targets for the 1985 program under the arrangement are presented in Appendix III.

2/ A major earthquake struck the central region of Chile in March 1985, causing losses estimated at 5 percent of GDP. In each of the years 1985 and 1986, the cost of the public sector reconstruction program has been estimated at about 0.5 percent of GDP. The limit for 1985 included an amount for contingency spending for earthquake damage repair amounting to US$7.4 million, or less than 0.1 percent of GDP. Initially, it was expected that the contingency spending would amount to the equivalent of 0.5 percent of GDP, to be fully financed externally.

Table 3. Chile: Main Economic Indicators 1982-86

(Percentage changes unless otherwise specified)

	1982	1983	1984	Prel. 1985	1986 Prog. Orig.	1986 Prog. Rev.
Real GDP	-14.1	-0.7	6.3	2.4	3.5	4.5
Real private consumption	-12.1	-3.4	1.2	-1.1	1.7	3.2
Real wages 1/	-12.9	-4.2	-3.8	1.9	...	...
Import volume	-39.4	-14.6	20.1	-11.4	4.3	5.4
Export volume	14.6	3.1	4.2	9.2	5.5	4.3
Terms of trade	-9.5	9.8	-7.5	-5.4	0.5	4.4
Consumer price index 1/	20.7	23.1	23.0	26.4	18.0	18.0
Nominal exchange rate 1/2/	85.6	20.3	45.0	44.6	13.8	13.8
Real effective exchange rate 1/3/	40.9	-6.0	13.6	27.3	--	--
National unemployment rate (as percent of labor force) 4/5/	19.6	14.6	14.0	11.9	...	...
Current account deficit (In millions of U.S. dollars)	2,304	1,073	2,060	1,307	1,300	1,181

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

1/ December-December.
2/ Pesos per U.S. dollar.
3/ Decline indicates appreciation.
4/ October-December.
5/ The survey methodology was changed as of the fourth quarter of 1985. Hence, the 1985 figure is not comparable to the previous ones.

Table 4. Chile: Macroeconomic Flows

(In percent of GDP)

	1982	1983	1984	Prel. 1985	1986 Prog. Orig.	1986 Prog. Rev.
I. Balance of Payments 1/						
Current account balance	-9.5	-5.4	-10.7	-8.2	-8.0	-7.1
Trade balance	0.3	5.1	1.5	4.9	5.1	5.7
Exports	15.2	19.4	19.0	23.4	24.7	24.2
Imports	-14.9	-14.3	-17.5	-18.5	-19.6	-18.5
Net factor payments	-7.9	-8.6	-10.2	-11.9	-11.3	-11.0
Other services and transfers	-1.9	-1.9	-2.0	-1.2	-1.8	-1.8
Capital account balance	3.8	2.4	10.3	8.2	8.1	7.4
Nonfinancial public sector	2.2	-1.0	2.7	4.1	4.5	4.2
Financial system n.i.e.	1.6	5.0	6.6	6.5	3.6	2.8
Public sector 2/	2.2	9.2	7.6	5.4	2.4	2.8
Rest	-0.6	-4.2	-1.0	1.2	1.2	—
Private capital and other	—	-1.6	1.0	-2.4	—	0.4
Net official reserves (increase -)	5.7	3.0	0.4	—	-0.1	-0.3
II. Aggregate Expenditure, Savings, and Investment						
Aggretate domestic expenditure	101.9	97.3	101.1	97.2	97.1	96.9
Consumption	90.6	87.5	87.5	83.5	82.3	81.2
Gross domestic investment	11.3	9.8	13.6	13.7	14.8	15.7
Nonfinancial public sector	4.7	4.9	6.0	7.0	7.6	7.5
Private sector and inventories	6.6	4.9	7.6	6.7	7.2	8.2
External savings	9.5	5.4	10.7	8.2	8.0	7.1
National savings	1.8	4.4	2.9	5.5	6.8	8.6
Nonfinancial public sector	-0.8	-0.1	0.6	3.8	4.2	4.3
Private sector	2.6	4.5	2.3	1.7	2.6	4.3
Domestic savings	9.7	13.0	13.1	17.4	18.1	19.6
III. Nonfinancial public sector						
Savings	-0.8	-0.1	0.6	3.8 3/	4.2	4.3
Net capital revenue	2.1	2.0	1.1	0.6	1.1	1.0
Capital expenditure	4.7	4.9	6.0	7.0 3/	7.6	7.5
Overall balance	-3.4	-3.0	-4.3	-2.6	-2.3	-2.2
Financing	3.4	3.0	4.3	2.6	2.3	2.2
External	2.2	-1.0	2.7	4.1	4.5	4.2
Domestic	1.2	4.0	1.6	-1.5	-2.2	-2.0
Of which: financial system	4.9	2.7	2.8	-0.5	-2.1	-2.2
Overall balance adjusted for net capital revenues	-5.5	-4.9	-5.4	-3.2	-3.4	-3.1

Table 4. Chile: Macroeconomic Flows (Concluded)

(In percent of GDP)

	1982	1983	1984	Prel. 1985	1986 Prog. Orig.	1986 Prog. Rev.
IV. Monetary Flows of the Financial System 4/						
Money and quasi-money	3.8	4.8	9.2	14.9	9.0	10.3
Net domestic assets	11.1	12.8	16.2	21.4	12.5	12.8
Credit to nonfinancial public sector (net)	4.9	2.7	2.8	-0.5	-2.1	-2.2
Credit to private sector	24.5	12.4	22.2	19.2	18.3	18.6
Other	-18.3	-2.3	-8.8	2.7	-3.7	-3.6
Net foreign assets	-7.3	-8.0	-7.0	-6.5	-3.5	-2.5
Net official reserves	-5.7	-3.0	-0.4	--	0.1	0.3
Other	-1.6	-5.0	-6.8	-6.5	-3.6	-2.8
V. Underlying Basic Data						
Real GDP (annual percent change)	-14.1	-0.7	6.3	2.4	3.5	4.5
Nominal GDP (billions of pesos)	1,239	1,558	1,893	2,577	3,192	3,277
Nominal GDP (billions of U.S. dollars, at average market exchange rates)	24.3	19.8	19.2	16.1	16.3	16.7
Average market exchange rates (pesos per U.S. dollar)	50.9	78.8	98.5	160.9	196.3	195.8
Copper prices (U.S cents per pound)	67.1	72.2	62.5	64.3	68.0	66.4
U.S. prime rate (in percent)	14.7	10.8	12.0	9.9	9.5	9.0
Consumer prices (12-month percent change)	20.7	23.1	23.0	26.4	18.0	18.0
Consumer prices (period average change)	9.9	27.2	19.9	30.7	20.0	20.2

Sources: Chilean authorities; and Fund staff estimates.

1/ As percent of GDP in U.S. dollars at average market exchange rates.
2/ Including Central Bank of Chile valuation adjustments.
3/ Incorporates adjustment for differences in measurement of fiscal operations.
4/ Flows denominated in foreign currency measured at the corresponding average market exchange rate.

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

(In percent of GDP)

	1982	1983	1984	1985 Prog.	1985 Prel.	1986 Prog. Orig.	1986 Prog. Rev.
General government current revenue	29.9	27.7	28.7	29.3	28.6	27.4	26.8
Taxes on income and property	5.7	5.0	4.6	3.2	3.7	4.5	3.8
Taxes on goods and services	13.5	13.5	14.3	14.8	15.1	14.5	15.1
Taxes on international trade	1.4	2.3	3.3	5.0	3.6	3.5	3.2
Social security tax	3.3	2.8	2.8	2.4	2.4	2.4	2.3
Other tax (net of IVA rebate)	-1.2	-1.2	-1.3	-1.1	-1.7	-1.7	-1.9
Nontax revenue	7.2	5.3	5.0	4.9	5.4	4.2	4.3
Operational surplus of the public enterprises	8.2	11.5	10.9	12.6	14.3	14.0	13.7
Of which: CODELCO	2.5	4.3	3.1	4.3	5.7	5.5	6.1
ENAP	3.5	4.7	5.0	5.7	5.6	5.4	4.5
Net transfers of public enterprises 1/	-7.1	-8.7	-8.3	-9.2	-9.6	-10.2	-9.9
General government current expenditure	31.9	30.5	30.7	29.5	29.5	27.0	26.3
Wages and salaries	7.8	6.7	6.4	5.5	5.8	5.4	5.2
Goods and services	3.3	3.2	3.4	2.9	3.2	2.7	2.7
Social security payments to private recipients	10.8	9.6	10.1	9.6	9.0	8.6	8.5
Transfer and subsidy payments to private sector	9.0	8.9	8.2	8.5	8.0	7.7	7.4
Interest on public debt 2/	0.6	1.8	2.4	2.7	3.2	2.3	2.3
Other	0.4	0.3	0.2	0.2	0.3	0.3	0.2
Current account surplus of the public sector	-0.8	-0.1	0.6	3.2	3.8	4.2	4.3
Net capital revenue 3/	2.1	2.0	1.1	1.0	0.6	1.1	1.0
Revenue	7.8	4.0	3.4	2.8	3.3	3.1	3.1
Less: financial investment 4/	-5.7	-2.0	-2.3	-1.8	-2.7	-2.0	-2.1
Capital formation	4.7	4.9	6.0	7.2	7.0	7.6	7.5
General government	2.1	2.3	2.3	3.4	3.1	3.5	3.3
Public enterprises	2.6	2.6	3.7	3.9	3.9	4.1	4.1
Overall surplus or deficit (-)	-3.4	-3.0	-4.3	-3.0	-2.6	-2.3	-2.2
Financing	3.4	3.0	4.3	3.0	2.6	2.3	2.2
External	2.2	-1.0	2.7	1.4	4.1	4.5	4.2
Internal	1.2	4.0	1.6	1.6	-1.5	-2.2	-2.0
Memorandum items							
Nominal GDP (in billions of Chilean pesos)	1,239	1,558	1,893	2,625	2,577	3,192	3,277
Overall balance adjusted for net capital revenue	5.5	4.9	5.4	4.0	3.2	3.4	3.1
Total revenue	33.2	32.3	32.4	33.7	34.0	32.3	31.6
Total expenditure	36.6	35.3	36.7	36.7	36.6	34.6	33.8

Sources: Ministry of Finance; and Central Bank of Chile.

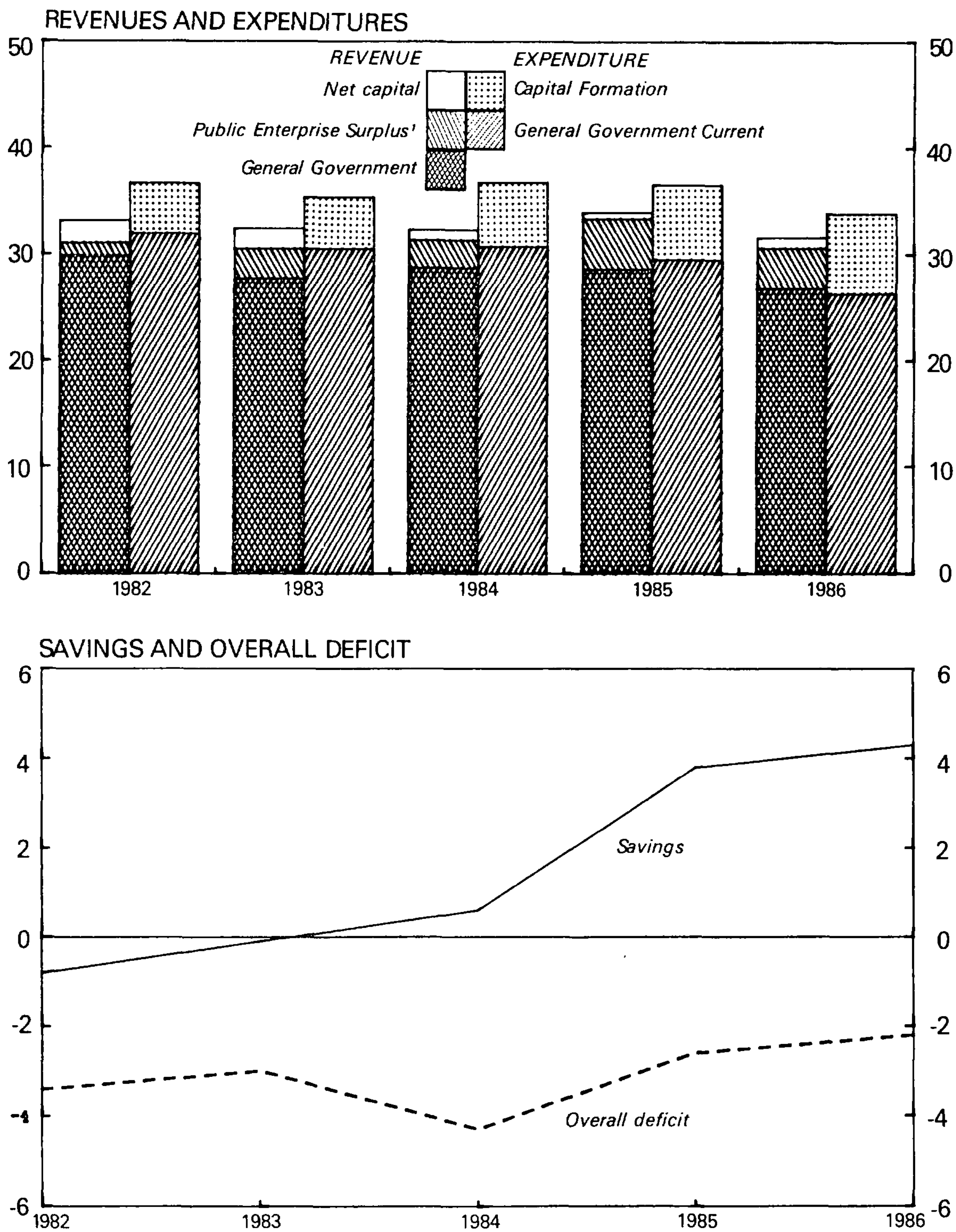
1/ Includes tax payments and transfers of profits by the public enterprises already incorporated into general government revenues.
2/ Includes monetary correction on indexed debt.
3/ Net capital revenue includes the net sale of assets by the public social security funds, which are in the process of being liquidated, as well as sales of shares in the public enterprises described in the text.
4/ Excludes net lending by CORFO and INDAP up to program limits in conjunction with special lending programs of the IDB and IBRD.

CHART 1

CHILE

OPERATIONS OF THE NONFINANCIAL PUBLIC SECTOR

(Percent of GDP)



Source: Ministry of Finance and Fund staff estimates.
[1] Net of taxes and transfers.

Over the same period, public sector investment rose by 1 percentage point of GDP, partly because of emergency reconstruction expenditures. The overall nonfinancial public sector balance adjusted for net capital revenue (overall borrowing requirement) declined by more than the overall deficit, from 5.4 percent of GDP in 1984 to 3.2 percent of GDP in 1985, as net capital revenue dropped by the equivalent of 0.5 percent of GDP.

Current revenue of the general government remained about in line with 1984 as a percent of GDP but was below program projections by 0.7 percentage points of GDP. Taxes on international trade fell short of projections by 1.4 percentage points of GDP because of the reduction in the import tariff at a faster pace and by larger amounts than had been incorporated in the program. In addition, value added tax rebates to exporters exceeded original projections by 0.6 percentage points of GDP because of higher exports. These shortfalls were partly offset by better than projected yields on income and property taxes, gross value added taxes, and nontax revenue. The performance of public sector enterprises in 1985 was a major factor contributing to the significant improvement in public sector savings. In particular, CODELCO's performance benefited from larger than projected exports of copper and the real devaluation of the peso, which more than offset the adverse impact of lower than expected copper prices.

General government current expenditures were reduced by 1.2 percentage points of GDP from 1984, to a level equivalent to 29.5 percent of GDP in 1985, in line with program projections. The restraint on expenditures was achieved by postponing and partially suspending the cost of living adjustment for public social security fund recipients in mid-1985 and by cutbacks in subsidy and transfer payments.

Monetary policy was managed with prudence during 1985. During the first nine months of the year the authorities kept the net domestic assets of the Central Bank below the program ceilings pending the completion of the financial package with commercial banks. In the last quarter of the year, as the growth of currency in circulation fell short of the projections, the authorities continued to hold net domestic assets below the program ceiling in order to assure achievement of the target for net international reserves.

In accordance with the objectives of the program, the Central Bank cut back its selective credit programs, limited its debt refinancing programs, and started to reduce and phase out the preferential exchange rate and swap subsidies. 1/ The interest rate subsidy on swap

1/ The operating losses of the Central Bank arising from the swap and preferential exchange rate subsidies amounted to an estimated 2.0 percent of GDP in 1984 and an estimated 6.7 percent in 1985. The larger losses in 1985 reflected the real depreciation of the peso during the year. Total operating losses of the Central Bank have been estimated at 0.7 percent of GDP in 1984 and 2.3 percent in 1985.

operations with foreign exchange resources obtained since February 1983 was lowered in several stages, from 4.6 percent a year in May 1985 to 2.9 percent a year in January 1986. 1/ A new schedule of interest rate subsidies was announced on May 8, 1986, with differential premia for varying maturities, and a further reduction was announced on June 10. After the most recent reduction, the premium stands at 2.0 percent for swaps of up to 29 days. A maximum premium of 2.6 percent applies for maturities between 181 and 360 days (a newly established category). A schedule has been established for the subsequent reduction and elimination in the first half of 1987 of the interest rate subsidy on swap operations (see Section III. 2.a. below).

The preferential exchange rate subsidy on eligible debt in excess of US$50,000 is also being phased out and will be eliminated by the end of 1986. The subsidy continues to apply temporarily to debt servicing for obligations of less than US$50,000.

During 1985 the authorities continued their efforts to strengthen the private financial system. Legislation was enacted that provided for the recapitalization of the intervened private banks and enabled the Government to participate in the recapitalization for up to 49 percent of their capital and reserves. These banks also were allowed to sell substandard portfolio to the Central Bank to improve their solvency and liquidity.

The net domestic assets of the financial system expanded by 57 percent during 1985 (Table 6) whereas the program had initially anticipated an expansion of 46 percent, in large part reflecting the effect of the preferential exchange rate subsidy. 2/ The net foreign liabilities of the financial system increased by less than had been expected as the SAL and cofinancing loans were channelled through the Treasury and not through the Central Bank as originally envisaged. The liabilities of the financial system to the private sector rose by 53 percent or 21 percent in real terms, whereas the program had assumed an increase of about 8 percent in real terms (Chart 2). This development reflected a better than expected performance by the private social security funds as well as a higher than expected real demand for financial assets by the rest of the private sector.

Since the beginning of their operations in 1981, the private social security funds have registered large operational surpluses which have been invested principally in financial system instruments and treasury notes. In 1985, the operating surplus of the funds amounted to about

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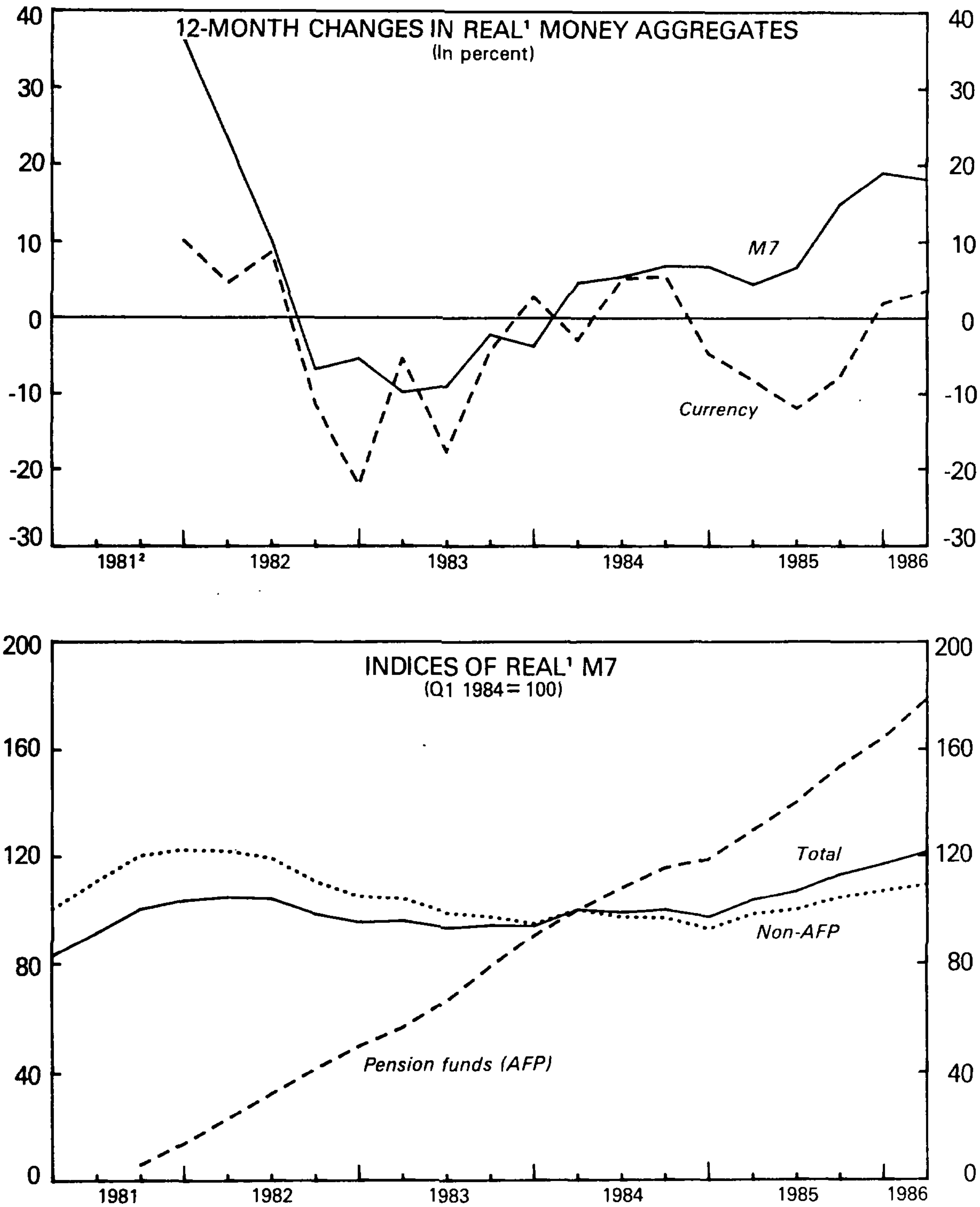
1/ For a detailed description of the operations, see EBS/86/20, p. 10.

2/ Although the authorities implemented on July 1, 1985, a schedule for the elimination of the preferential dollar subsidy for debt in excess of US$50,000, for 1985 as a whole the amount of the subsidy was larger than programmed because of the devaluation of the peso in February and June of that year.

CHART 2

CHILE

MONETARY INDICATORS



Sources: Central Bank of Chile and Fund staff estimates.
[1] Deflated by the consumer price index.
[2] M7 data series first collected December 1980.

Table 6. Chile: Monetary Indicators 1/

	1984	1985 1st Qtr.	1985 2nd Qtr.	1985 3rd Qtr.	1985 4th Qtr.	1985 Year	1986 1st. Qtr.	1986 Proj. Year
A. Central Bank								
(Change in millions of U.S. dollars)								
Net international reserves 2/	-82.0	-315.0	-281.0	-171.0	772.0 3/	5.0 3/	-95.0	50.0
Medium- and long-term foreign liabilities 4/	825.0	-3.0	-7.0	-6.0	814.0	798.0	148.0	630.0
(Percentage change)								
Net domestic assets 5/	164.0	60.9	49.7	27.9	29.4 3/	172.2 3/	56.6	151.2
Liabilities to the private sector 6/	20.7	5.0	—	-3.6	20.4	21.8	5.2	23.8
B. Financial System								
(Change in millions of U.S. dollars)								
Net international reserves	619.0 7/	-303.0	-461.0	-199.0	718.0	-245.0	-118.0	-27.0
Medium- and long-term foreign liabilities 8/	1,976.0 7/	38.0	74.0	121.0	669.0	902.0	149.0	388.0
(Percentage change) 9/								
Net domestic assets	54.1	17.6	11.7	14.6	4.0	56.5	7.4	23.6
Of which: credit to the public sector (net) 10/	101.3	36.1	13.9	0.4	-43.1	-11.6	-11.6	-69.2
credit to the private sector	34.7	8.2	10.9	3.8	4.6	30.3	5.1	28.6
Liabilities to the private sector 11/	31.4	14.0	10.5	11.8	8.7	53.0	8.7	30.4
Memorandum items:								
Inflation rate (CPI)	23.0	8.2	8.2	3.4	4.4	26.4	5.2	18.0
Change in exchange rate (pesos per U.S. dollar) 12/	46.0	14.7	15.2	3.7	2.8	40.9	3.4	13.8

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

1/ Based on end-of-period data.
2/ Program definition. Based on cross-parities of December 1984 for 1985, and on cross-parities of December 1985 for 1986.
3/ 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, to be made in 1986.
4/ Program definition. Includes SAL and cofinancing disbursements, but excludes foreign liabilities due to deposits placed by the private and public sectors in the Central Bank on account of the rescheduling agreements with foreign banks. These deposits are included in net domestic assets.
5/ As percent of liabilities to the private sector at the beginning of the period. Foreign currency flows during each period are valued at the accounting exchange rates of the program.
6/ Consists primarily of currency in the hands of the public. Excludes Central Bank notes (pagares), which are included in net domestic assets.
7/ Flows include the conversion of short-term foreign liabilities to medium-term foreign liabilities.
8/ Includes deposits placed at the Central Bank by the public and private sectors on account of the rescheduling agreements. Excludes SAL and cofinancing.
9/ Changes with respect to the stock outstanding at the end of the previous period. Foreign currency components are valued at the exchange rates of each period.
10/ Excludes holdings of treasury notes on account of the 1983-85 capitalization of the Central Bank.
11/ Consists of currency in the hands of the public, demand deposits, savings deposits, central bank notes, letters of credit, and foreign currency deposits.
12/ End-of-period official exchange rate.

4.6 percent of GDP and their holdings of paper issued by the financial system rose by 45 percent in real terms. The financial assets held by the rest of the private sector, which declined significantly in real terms during 1982-83, remained about constant in 1984. For 1985, the economic program assumed an increase of about 4 percent in real terms. In the event, however, they rose by about 16 percent, reflecting improved confidence and the increase in the preferential exchange rate notes issued by the Central Bank as a result of the real depreciation of the peso that took place in 1985. 1/

In the external sector, the authorities followed policies designed to strengthen the international competitiveness of the economy. The uniform import tariff rate was reduced in two steps from 35 percent at the beginning of the year to 20 percent in June 1985. The peso experienced two step devaluations in February and June 1985 and continues to be depreciated daily against the U.S. dollar on the basis of the difference between the rate of inflation in Chile and in its main trading partners. In real effective terms the peso depreciated by 12 percent in 1984, by 22 percent in 1985, and by 5 percent during the first four months of 1986, reflecting in part the depreciation of the U.S. dollar vis-a-vis other major currencies (Chart 3).

The improved competitiveness of the economy and tight demand management contributed to a decline in the current account deficit of about US$750 million, reflecting mainly an improvement in the trade balance by US$500 million, which resulted in a surplus of close to US$790 million or slightly higher than the estimate presented to the Executive Board when the arrangement was approved (EBS/85/122, Sup. 1) (Table 7 and Chart 4). The volume of copper exports increased by 10 percent, considerably more than programmed, while the volume of noncopper exports rose by 9 percent, somewhat above the program estimates. However, export prices were lower than projected, as noncopper export prices declined by 11 percent. As a result, total export earnings (in U.S. dollar terms) were only 2.5 percent higher than in 1984. The value of imports declined by 12 percent, which was slightly more than programmed.

The external current account deficit declined from US$2,060 million in 1984 to US$1,307 million in 1985, in line with the program target. Net interest payments abroad and other service payments were broadly in line with the program. Compared with 1984, interest payments declined by US$136 million, as lower interest rates and a one time reprogramming in interest payments to commercial banks amounting to US$140 million more than offset the impact of a higher level of external debt. Net payments on nonfactor services declined by US$240 million as a result of

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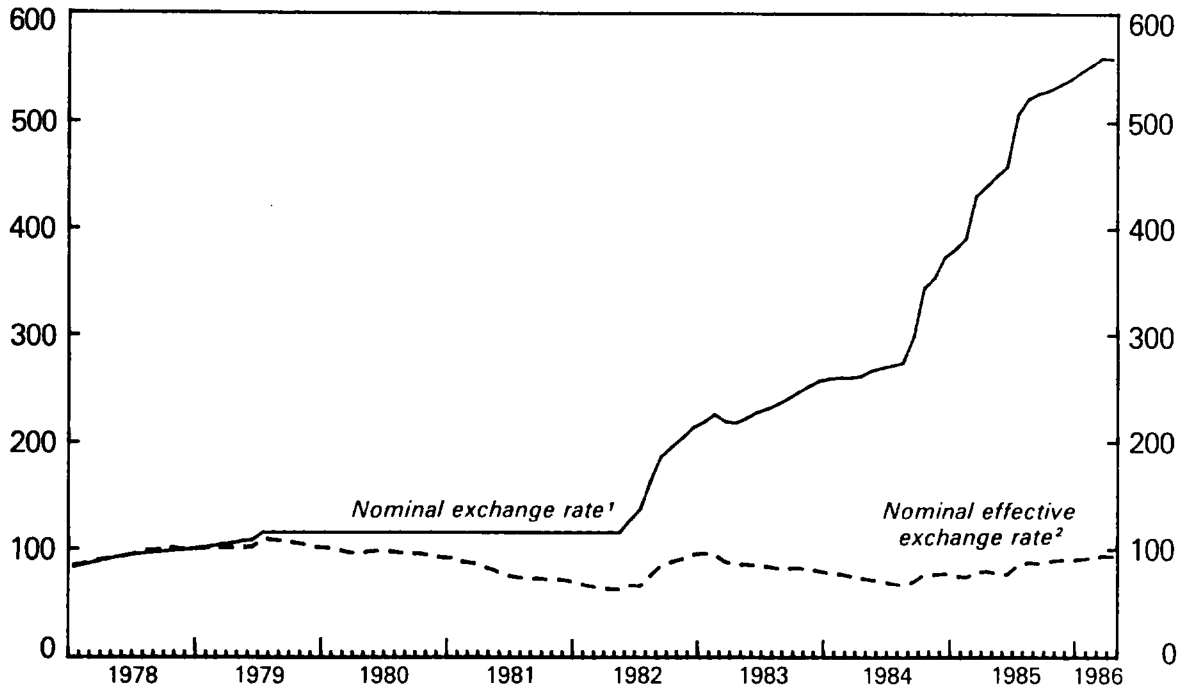
1/ The Central Bank provides the preferential exchange rate subsidy through the issuance of notes with maturity of eight to ten years, in order to restrict the monetary impact of the subsidy in the short term. If these notes are excluded, the financial assets held by the rest of the private sector increased by about 8 percent in real terms in 1985.

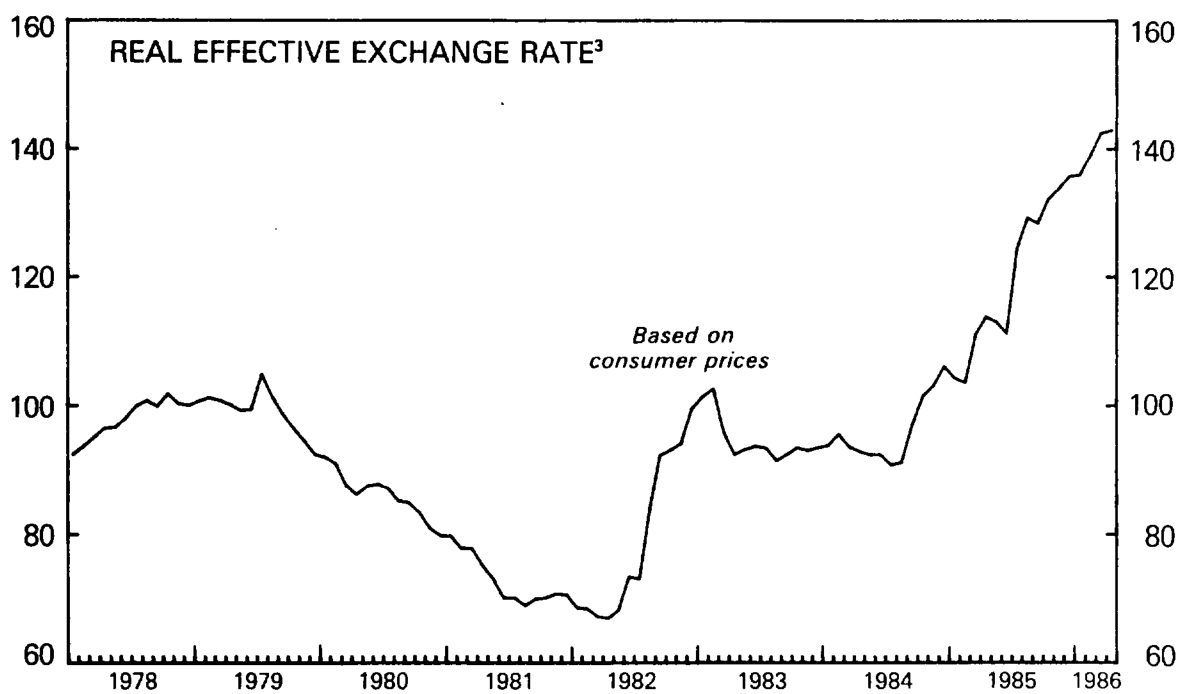
CHART 3

CHILE

EXCHANGE RATE INDICES

(Dec. 1978=100)





Sources: Central Bank of Chile; *International Financial Statistics;* and Fund staff estimates.
[1]Pesos per U.S. dollar at end of period.
[2]Nominal exchange rate index adjusted by a weighted index of exchange rate movements of major trading partners.
[3]Real exchange rate index adjusted by weighted indices of prices and exchange rate movements of major trading partners.

CHART 4

CHILE

BALANCE OF PAYMENTS

(In millions of U.S. dollars)

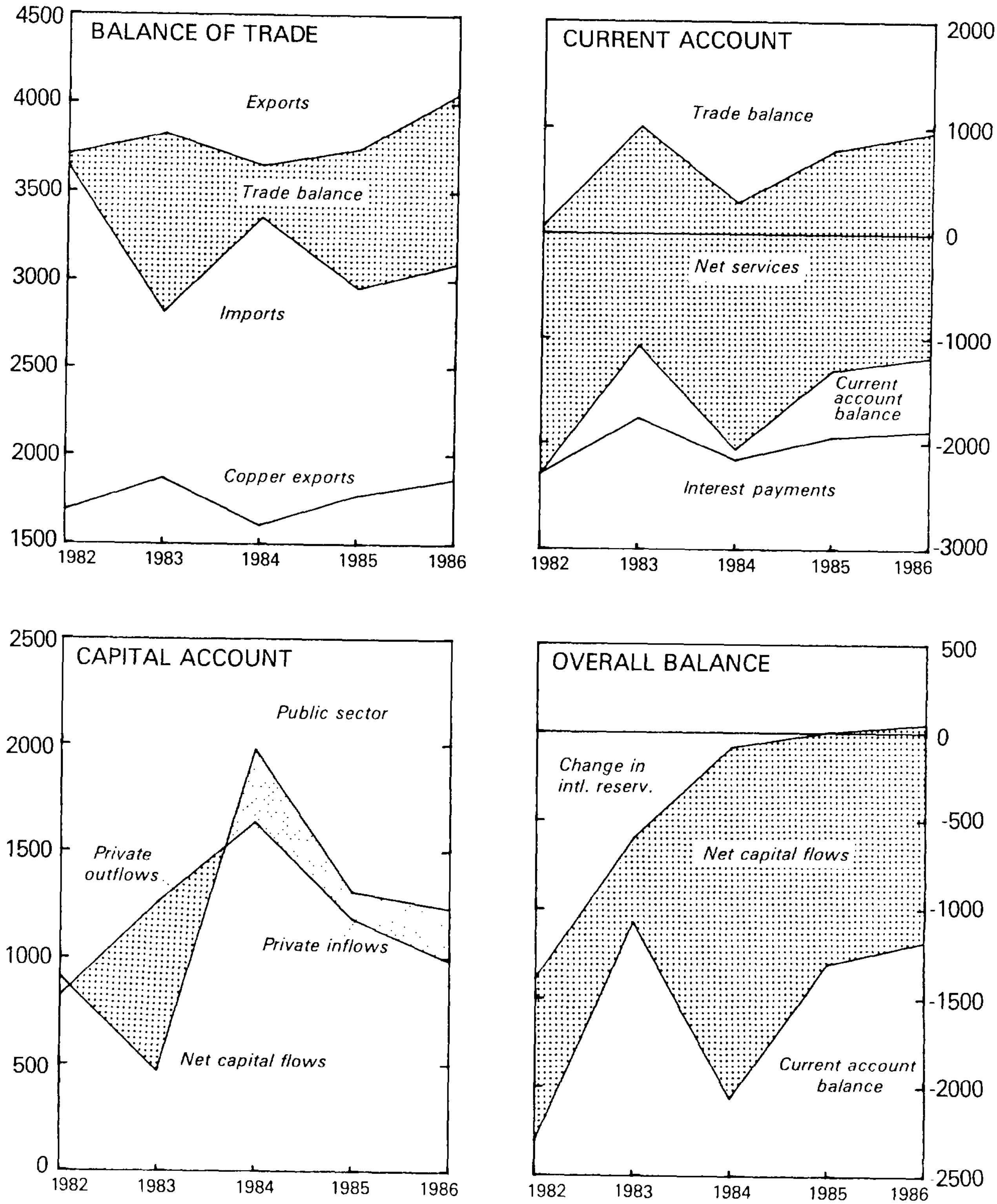


Table 7. Chile: Balance of Payments, 1982-86

(In millions of U.S. dollars)

	1982	1983	1984	1985 Program	1985 Preliminary	1986 Program	1986 Revised Program
Current account	-2,304	-1,073	-2,060	-1,298 1/	-1,307 1/	-1,300 2/	-1,181
Trade balance	63	1,009	293	754	788	836	956
Exports	(3,706)	(3,827)	(3,650)	(3,730)	(3,743)	(4,013)	(4,052)
Copper	/1,685/	/1,871/	/1,604/	/1,727/	/1,770/	/1,825/	/1,864/
Other	/2,021/	/1,956/	/2,046/	/2,003/	/1,973/	/2,188/	/2,188/
Imports	(-3,643)	(-2,818)	(-3,357)	(-2,976)	(-2,955)	(-3,177)	(-3,097)
Nonfinancial services	-555	-471	-497	-358 3/	-255 3/	-366	-353
Financial services	-1,921	-1,703	-1,955	-1,794 1/	-1,901 1/	-1,830 2/	-1,844
Transfers	109	92	99	100	61	60	60
Capital account	1,015	388	1,790	1,377	1,494	1,315	1,121
Direct investment	384	148	67	115	112	110	187
Scheduled amortization	-1,206	-1,814	-1,507	-2,284	-2,247	-2,723	-2,723
Extraordinary amortization	-42 4/	--	--	--	-206 5/	-210 5/	-539
Medium- and long-term disbursements	2,619	646	792	764	632	793	656
Nonfinancial public sector	(1,025)	(293)	(587)	(529)	(484)	(563)	(462)
Of which: IBRD and IDB	/64/	/230/	/341/	/441/	/363/	/436/	/325/
Private sector 6/	(1,594)	(353)	(205)	(235)	(147)	(230)	(194)
Change in medium- and long-term assets 7/	9	17	9	10	172	188	414
Short-term capital	-534	-955	596	147	316	232	244
Nonfinancial public sector	(-19)	(-231)	(129)	(40)	(35)	(80)	(79)
Private sector 6/ 8/	(-515)	(-724)	(467)	(107)	(281)	(152)	(165)
Commercial credits	-216	-103	-6	-28	49	-22	-26
Extraordinary financing	--	2,450	1,839	2,653	2,666	2,946	2,908
Refinancing of maturities due	(--)	(1,150)	(1,019)	(1,814)	(1,827)	(2,300)	(2,263)
By foreign banks	/--/	/1,150/	/1,019/	/1,747/	/1,760/	/2,197/	/2,197/
By foreign governments	/--/	/--/	/--/	/67/	/67/	/103/	/66/
IBRD Structural adjustment loan	(--)	(--)	(--)	(125)	(125)	(275)	(275)
New money from foreign banks	(--)	(1,300)	(820)	(520)	(520)	(265)	(264)
Co-financing loan from foreign banks	(--)	(--)	(--)	(194)	(194)	(106)	(106)
Errors and omissions	-76	45	107	-52	-131	--	110
Overall balance of payments	-1,365	-641	-163	27	56	15	50
Valuation adjustment of official reserves	-28	38	81	-27	-52	--	--
Change in official reserves (increase -)	1,393	603	82	--	-4 9/	-15	-50

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

1/ Includes interest savings of US$140 million from change in interest payment date (part of the 1985-86 financial package).
2/ Includes interest savings of US$55 million on account of repricing of certain foreign bank loans (part of the 1985-86 financial package).
3/ Includes US$63 million in insurance payments on account of the March 11, 1985 earthquake.
4/ Prepayment of debt.
5/ Prepayment of debt through purchases abroad of Chilean external debt at a discount; counter entries are made mainly under change in medium-term and long-term assets (Article XVIII) and to a lesser extent under direct foreign investment (Article XIX).
6/ Includes Banco del Estado.
7/ Includes counter entries for prepayment of debt at a discount. These were previously included under private short-term capital movements.
8/ Includes counter entry for net tourist expenditures financed in the parallel market.
9/ Includes an adjustment to net international reserves for a provision of US$15 million to cover cash payments related to the rescheduling agreement with Chile's main official creditors which were effected in early 1986.

the receipt of insurance payments (US$65 million) related to earthquake damage and lower freight costs.

The overall balance of payments, as measured by the change in the net international reserves of the Central Bank, showed a surplus of US$4 million in 1985. Net medium- and long-term capital inflows to the public sector were in line with original estimates. However, direct investment and net medium- and long-term disbursements to the private sector fell short of the projections by about US$90 million. This shortfall was offset by a larger than programmed inflow of short-term capital, reflecting mainly a drawdown of private assets abroad.

b. Developments in 1986

During the early part of 1986 the performance of the Chilean economy was relatively strong. Industrial output continued to expand in the first quarter of the year--by some 5 percent according to a preliminary estimate. Agricultural production also increased rapidly, with fruit exports having reached record levels in recent months. At the same time, inflation has continued to decline. Aided by the reduction in domestic petroleum prices, the cumulative rate of increase in the consumer price index during the first five months of the year was 7.4 percent, compared with 12.9 percent in the same period of 1985.

The balance of payments for the first quarter of the year showed a stronger outcome than originally projected, as the trade balance and the current account improved because of lower petroleum prices and a decline in non oil imports below the level originally projected (Statistical Appendix Table 14). Part of the improvement in the balance of payments reflected short-term private flows that were considerably higher than previously projected, more than offsetting shortfalls in medium- and long-term capital. In reflection of these developments, the overall balance of payments recorded a deficit of US$100 million in the first quarter of 1986, some US$86 million less than programmed for the period.

In the first quarter of 1986, the overall public sector deficit declined to Ch$12.1 billion (0.4 percent of GDP), or about one half the level of the program projection. This outturn resulted from a stronger than projected revenue performance associated with the economic upturn and a slowdown in expenditure. The operational surplus of the public sector enterprises, however, declined from the very high level observed in the fourth quarter of 1985, primarily because of special factors affecting CODELCO and the Chilean petroleum company (ENAP). CODELCO's operating surplus tapered off in the first quarter of 1986 as copper exports declined from the seasonally high levels observed in late 1985. ENAP's operating surplus in the first quarter of 1986 was adversely affected by the reductions in domestic prices of refined products.

The net domestic assets of the Central Bank remained well below the ceiling in the first quarter of the year. The Central Bank did not allow the short-term capital inflows to be reflected in credit expansion, thus helping to strengthen Chile's reserve position. Although the real growth of currency in the first quarter of the year was below the program projection, the demand for other financial assets by the private sector was somewhat stronger than anticipated. Real interest rates declined during the quarter as the annual rate on 90-365 day deposits fell from an average of 6.2 percent in December 1985 to an average of 4.6 percent in April 1986, consistent with the decline in interest rates in international capital markets (Chart 5).

III. Policy Issues and the Economic Program for 1986

The discussions for the Article IV consultation and the review under the extended arrangement centered on the assessment of the progress made toward the achievement of the program targets during the first year of the arrangement, the outlook for the remainder of 1986, and the policies to be pursued in order to achieve the program targets. As noted earlier, quantitative performance criteria were agreed for the remainder of 1986. While discussions were held on the prospects for 1987, the authorities were not in a position to make firm commitments for the full second year of the arrangement at this early stage of the budget cycle for 1987; those budget proposals will be submitted only late this year and the targets for 1987 and performance criteria for the first half of the year will be established during the forthcoming review.

The prospects for Chile's economy in 1986 have improved somewhat because of declines in petroleum prices and interest rates in international markets and increased confidence on the part of the public in the policies embodied in the adjustment program. Accordingly, the targets for all of 1986 have been revised to account for those improved conditions. The authorities have noted that copper prices in international markets remain weak and are not expected to improve to the extent envisaged at the time of the previous review. The outlook for petroleum prices, which declined dramatically through April 1986, is subject to considerable uncertainty and interest rates moved up somewhat recently. In these circumstances the Chilean authorities reiterated their commitment to the medium-term economic program initiated in 1985 and have taken actions to strengthen the fiscal adjustment effort by increasing petroleum taxes to offset the adverse impact of lower world petroleum prices on the revenues from domestic production (see Section 1.c. below). The authorities have emphasized that only through the firm pursuit of structural and demand policies could Chile attain sustained economic growth, increased domestic savings, and a reduced reliance on foreign savings.

The program for the remainder of 1986, described in the attached letter and memorandum of economic policies, envisages a small decline in the external current account deficit from US$1.3 billion (8.2 percent of GDP) in 1985 to US$1.18 billion (7.1 percent of GDP) in 1986. This target is based on an average price of copper of some US$0.664 a pound, (some 1.5 cents below earlier projections) and a petroleum price of US$16 (f.o.b.) a barrel for the remainder of the year. The program also envisages an increase of medium- and long-term debt of US$250 million in 1986, or US$400 million less than originally projected, offset in part by higher private short-term flows and direct investment. The overall balance of payments is projected to reach a surplus of US$50 million or US$35 million more than originally projected.

The improvement in the external account is compatible with the previously projected decline in the annual rate of inflation from some 26 percent in 1985 to 18 percent in 1986 and a rate of growth of real GDP of 4.5 percent in 1986, one percentage point higher than the original projection. Consumption is expected to increase at a lower pace than GDP, with per capita private consumption growing by somewhat over 1 percent after four years of decline. Gross capital formation has been projected to increase by some 11 percent in real terms and is expected to be financed by higher domestic savings from both the private and public sectors (see Table 4).

The program incorporates structural reform measures in several areas, in support of which the IBRD has granted a Structural Adjustment Loan (SAL) for US$250 million. These measures aim at strengthening the noncopper exports, public sector savings, and the efficiency of the public investment program, together with improving the financial conditions of the corporate and banking sectors. At present the Chilean authorities and the World Bank are conducting discussions on a second SAL, which is included in the World Bank lending program for 1986.

1. Fiscal policy

Improvement of the public sector finances continues to be at the center of the adjustment process. The revised program for 1986 envisages a reduction in the nonfinancial public sector deficit from the equivalent of 2.6 percent of GDP in 1985 to 2.2 percent in 1986, or Ch$71.9 billion (see Table 5 and Statistical Appendix Table 12). The revised fiscal objective entails a small revision from the previously projected deficit of 2.3 percent of GDP, or Ch$74 billion. The nonfinancial public sector deficit adjusted for net capital revenues, i.e., the overall financing requirement, is now projected to be reduced from the previously projected level equivalent to 3.4 percent of GDP to 3.1 percent.

Public sector savings, equivalent to 3.8 percent of GDP in 1985 and originally projected to increase to 4.2 percent of GDP in 1986, are now projected to be the equivalent of 4.3 percent. Public sector investment in 1986 is projected to be the equivalent of 7.5 percent of GDP, virtually the same as the original projection.

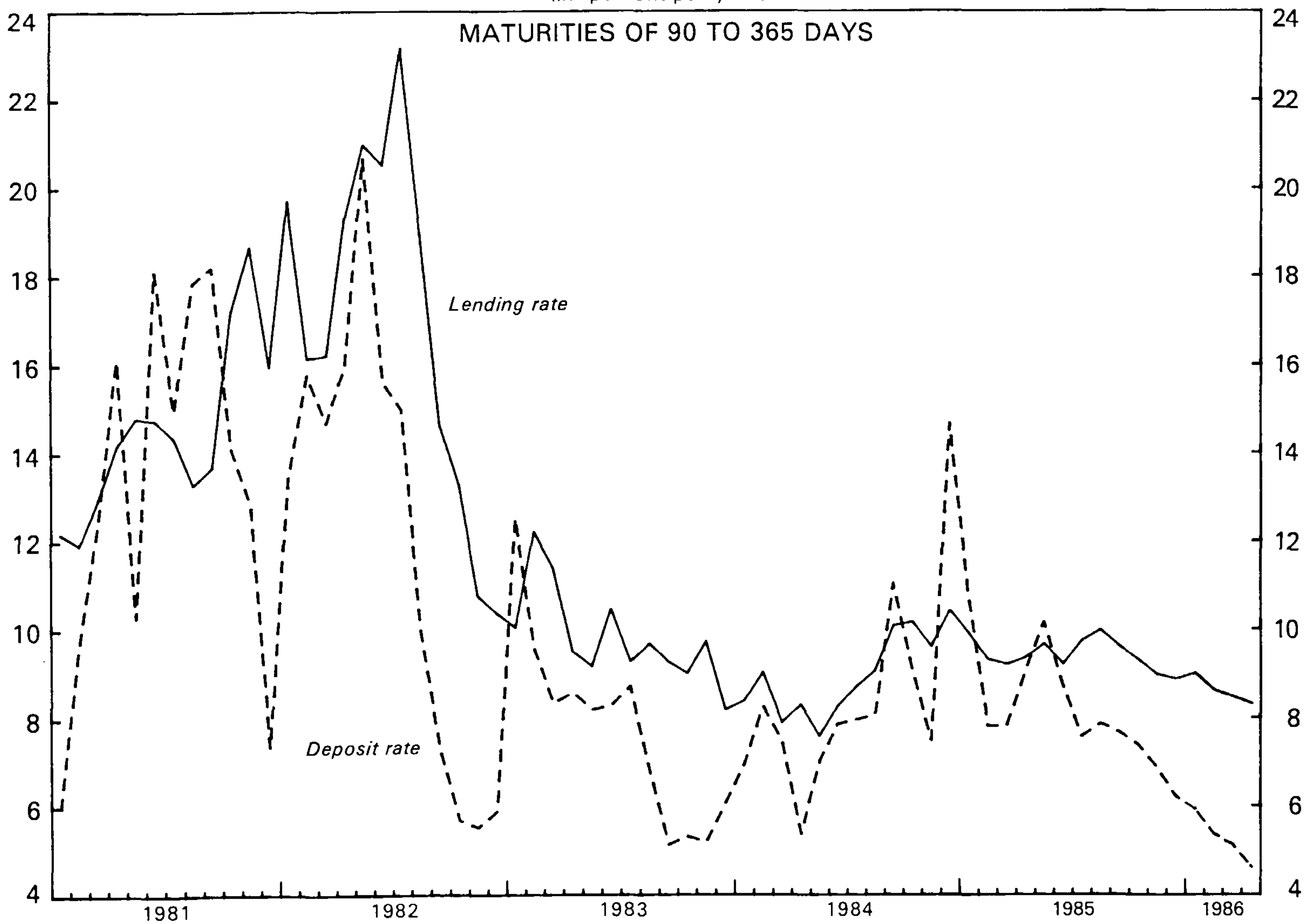
The revised nonfinancial public sector deficit will result in a somewhat smaller repayment of domestic debt than previously projected,

CHART 5

CHILE

REAL INTEREST RATES[1]

(In percent per year)



Source: Central Bank of Chile.

[1] Adjusted by actual inflation.

while foreign borrowing is expected to decline. External financing is expected to be the equivalent of some 4.2 percent of GDP; the public sector would make no net use of domestic nonbank financing and is expected to repay the equivalent of 2.2 percent of GDP to the banking system.

The Government has continued to implement the reform of the tax system in order to encourage higher rates of private saving and investment, but introduced several modifications at the beginning of 1986. The reduction in tax rates on personal income was postponed for two years to dampen the impact of the reform on overall general government revenues. The scheduled corporate surtax rate reduction, however, was implemented and a modification of the base was introduced to eliminate an existing source of double taxation. In addition, a clarification of the tax reform law was made, reaffirming the applicability of the corporate surtax to public sector enterprises.

The nonfinancial public sector deficit limits remain unchanged for the first half of the year, but the deficit for this period may end up somewhat smaller than originally projected. The relatively low deficit observed in the first quarter of the year reflects the postponement of certain expenditures to the third quarter, while the second quarter outcome may benefit from the somewhat stronger performance of the economy.

If the estimated operating losses of the Central Bank are added to the nonfinancial public sector, the proposed combined deficit would show a considerably larger adjustment than the 0.4 percentage points of GDP targeted for the nonfinancial public sector adjustment. The operating losses, equivalent to some 2.3 percent of GDP in 1985, are expected to disappear in 1986, mainly because of the elimination of existing subsidies on certain foreign currency loans.

a. Developments in revenues and expenditures 1/

The adjustment of the public finances continues to be based on restraint in current expenditure, as total public sector revenue will decline from 34.0 percent of GDP in 1985 to 31.6 percent in 1986. General government current revenue is projected to decline from 28.6 percent of GDP in 1985 to 26.8 percent in 1986, some 0.6 percentage points less than had been projected initially, mainly because of a decline in CODELCO's income tax liabilities in the wake of Chile's tax reform. The operational surplus of the public enterprises will be somewhat lower than originally envisaged, as the increased net revenues from CODELCO will offset only in part the lower revenues from ENAP. The reduced operational surplus of the public sector enterprises will be reflected in a lower level of transfers to the Central Government.

1/ For a detailed description of prospects for current revenue and expenditure in 1986 see Chile - Review Under the Extended Arrangement and Request for Modification and Waiver (EBS/86/20, 1/30/86).

Total expenditure is projected to decline from 36.6 percent of GDP in 1985 to 33.8 percent in 1986. Current expenditure of the general government is projected to decline from 29.5 percent of GDP in 1985 to some 26.3 percent in 1986, or 0.7 percentage points less than originally programmed. The performance of expenditure reflects continued restraint in most areas and the full year effect of the measures taken in 1985.

The Chilean authorities are firmly committed to keeping public sector expenditures within the budgeted limits and, as described in the following section, they will act to avoid that the emergence of any petroleum tax revenues in excess of the amounts needed to compensate other revenue losses are used to support additional expenditure.

Public sector capital formation during 1986 has now been targeted to increase by 0.5 percentage points of GDP to 7.5 percent of GDP, a level which reflects the needs emerging from the reconstruction effort associated with the March 1985 earthquake and, to a lesser extent, the requirements of some of the public enterprises seeking to expand their productive capacity. The public sector investment outlays for 1986 resulting from the reconstruction effort account for about 0.5 percent of GDP and are concentrated in the areas of housing, roads, ports, and water and sewerage.

A World Bank public investment review was updated by a mission that visited Chile during April/May 1986. The mission concluded that the 1986 public investment program includes high return, well justified projects, consistent with the government objectives to accelerate exports and improve the efficiency of the economy. A summary of the mission's findings is presented in Appendix II.

b. The impact of changes in petroleum prices on the public finances

The authorities have taken measures to offset the adverse impact of lower international petroleum prices on the public finances because of lower profits on domestic production. Those measures consist mainly of the introduction of a variable tax on gasoline and diesel oil consumption.

ENAP, the state petroleum company, produces about one-half of domestic consumption of petroleum. Historically, ENAP has established domestic prices for refined products on the basis of the Caribbean posted price for crude oil, thus changing these prices in line with world price movements. Accordingly, as world prices fell, several price reductions, averaging 16 percent, were announced for domestic petroleum derivatives which had the effect of reducing potential profits for ENAP. The decline in prices also affected adversely the central government finances through lower import duty and value added tax collections. The overall adverse effect of reduced petroleum prices on the public finances was estimated to be the equivalent of about 1.4 percent of GDP.

To compensate for this decline, the Chilean Government imposed, effective May 1986, a new tax on domestic consumption of gasoline and diesel oil, although a system of tax credits or rebates has been provided to industrial users of diesel oil. The new tax is equivalent to a fixed amount per liter plus a variable component which changes with the price of imported petroleum. The fixed tax is equivalent to three monthly tax units 1/ a cubic meter (approximately US$0.08 a liter) for gasoline and to 1.5 tax units a cubic meter (the equivalent of US$0.04 a liter) for diesel oil. The variable amount is equivalent to 70 percent of the difference between a reference price--US$233 a cubic meter for gasoline and US$196 for diesel oil--and the ENAP ex-refinery price of these products. The variable portion of the tax will be reduced to 50 percent of the price difference in 1987 and will be eliminated effective January 1, 1988. The new tax, equivalent to 69 percent of the ex-refinery price for premium gasoline at an import price of US$16 a barrel of crude oil, replaces a previously existing tax of 27 percent. The tax increase has not resulted in increased domestic prices because of a lag in the domestic price adjustment before the tax became effective. The revenues from the new tax (net of the existing tax) are expected to amount to the equivalent of 0.5 percent of GDP in the period May-December 1986. Additional savings, equivalent to some 0.3 percent of GDP, accrue to the public sector because its outlays on petroleum products will be lower. CODELCO, a primary beneficiary, will save the equivalent of some 0.2 percent of GDP. In total, after including the impact of the new petroleum taxes, the public sector will lose revenues equivalent to 0.6 percent of GDP from the decline in petroleum prices.

c. Other aspects of fiscal policy

In its efforts to reduce further its involvement in nonstrategic sectors of economic activity, the Government of Chile has started to sell shares held by the Chilean Development Corporation (CORFO) and its affiliates, as well as the shares of other public sector enterprises. The resources thus obtained are being used to support lending operations to the private sector, to finance the payment of pensions under the public pension plan now being phased out, and to help finance the public sector investment program. Total sales in 1986 are expected to amount to Ch$19.3 billion. To the extent that the sale of shares by the public sector exceeds the amounts now envisaged, the limits for the overall public sector deficit will be reduced by an equivalent amount, unless the additional resources are relent to the private sector in excess of the credit program included in the budget. 2/

1/ The monthly tax unit is indexed to inflation in the period two months earlier. On the basis of the exchange rate prevailing in May 1986, each tax unit is equivalent to US$28.

2/ Only specified lending activities are taken into account for the purpose of this adjustment, namely medium- and long-term loans provided by CORFO, INDAP, and SERCOTEC for programs partly supported by external resources provided by the World Bank and the IDB. These loans are granted on the basis of a careful evaluation of the projects being supported; they do not provide any explicit or implicit subsidies to the borrower and have been characterized in the past by a low default ratio.

2. Monetary policy

Monetary policy has continued to support the fiscal effort and is geared to the output, inflation, and balance of payments assumptions of the program. Monetary control during 1986 will be mainly achieved through restraint on central bank credit expansion.

a. Operations of the Central Bank

The authorities have made significant progress toward the elimination of the operating losses of the Central Bank during 1986; this was achieved by reducing the subsidies arising from the preferential exchange rate applied to the repayment of selected external debt and from interest subsidies on swap operations and related deposits in foreign currency. As noted previously, in order to eliminate operating losses, the interest rate subsidies on swap and related deposits will continue to be reduced until they are eliminated in the first half of 1987. The authorities intend to reduce on a monthly basis the interest rate premium on swaps made with external resources obtained after February 1983. The premium on the lower maturity swaps--up to 29 days--will be reduced in equal monthly changes and will be eliminated by February 28, 1987. The premium on new operations for all other maturities will be reduced in line with that for maturities of up to 29 days, and is to be eliminated no later than April 30, 1987. However, in order not to disrupt capital flows and to avoid abrupt changes in net international reserves, the authorities may need to reduce the spread at a somewhat different pace, while maintaining their commitment to eliminate the premia as programmed.

The preferential exchange rate subsidy is being reduced, and will be eliminated in late 1986, for debts in excess of US$50,000. Debt originally amounting to less than US$50,000--5 percent of the debt originally eligible for the subsidies--remains eligible but is expected to be fully repaid by the end of the program period, as the average maturitiy is six months. Based on these measures, the Central Bank's operating losses, which were the equivalent of 2.3 percent of GDP in 1985, are expected to be eliminated in 1986. Although losses are not expected to re-emerge in subsequent years, the institution could still incur capital losses on past credit operations because of higher foreign interest rates or a real depreciation of the currency. Hence, to the extent necessary, the Treasury will continue its policy of recapitalizing the Central Bank. The progress being made in eliminating the operating losses of the Central Bank and in reducing swap related subsidies will be part of the mid-term review of the program.

b. Monetary policy in 1986

During 1986 the Central Bank will continue to limit domestic debt refinancing programs to the commitments at the beginning of 1985 and it will continue to restrain selective credit operations. Continuation of these policies should enable the Central Bank to increase its reliance on nonselective operations to rechannel financial resources within the economy.

On the basis of the revised real GDP projections for the year, the growth of currency in circulation in real terms has been revised upward from 6 percent to 7 percent. Nevertheless, the programmed expansion of net domestic assets by the Central Bank has been tightened, in part reflecting lower external resources available to the Central Bank for domestic on-lending to the private sector 1/ and in line with the revised foreign reserve and inflation targets. Net domestic assets of the Central Bank are now expected to rise by about 18 percent (compared with 32 percent previously projected) with respect to the sum of its liabilities to the private sector and its medium- and long-term foreign liabilities.

The availability of credit to the private sector is not expected to be curtailed, as the overall borrowing requirement of the nonfinancial public sector (including capital revenue) has been reduced by about 0.3 percent of GDP. In addition, on the basis of the first quarter results, holdings of financial assets by the private sector are now projected to grow by 10.5 percent in real terms for the year compared with 6.5 percent previously. To a large extent, the increase in demand for financial assets in real terms is expected to be generated by the private social security funds, with the rest of the private sector increasing its real holdings by 6.4 percent.

c. Interest rate policy

Interest rates, which continue to be determined mainly by market forces, have remained positive in real terms, but have been declining in recent months (see Chart 5). The Central Bank provides a monthly indication of maximum nominal interest rates on 30-day deposits to financial institutions, based on the expected rate of inflation adjusted to take into account foreign interest rates and other developments. The policy seeks to provide positive real interest rates, but the Government is committed to eliminating the indicative rate as the financial system becomes stronger. The reduction of inflation and a lower public sector deficit have allowed nominal interest rates to decline in recent months, although with a small lag compared with foreign interest rates. This has helped preserve the competitiveness of domestic financial instruments, as evidenced by the continued strong growth of real financial assets held by the private sector and by private capital inflows from abroad. These capital inflows have continued notwithstanding the reduction in the subsidies granted to swap operations and a reduction in the spread over LIBOR on foreign currency denominated instruments issued by the Central Bank, announced in May 1986.

1/ An IDB loan that was to be channeled through the Central Bank for industrial restructuring (of which US$50 million was expected to be disbursed in 1986) has been delayed.

d. Measures to strengthen the financial system

The authorities continue to aim at the re-establishment of a solvent private financial system and are being supported in this effort by the World Bank in the context of the SAL I and proposed SAL II loans. The position of the private banks has improved as a result of the purchase by the Central Bank of part of their substandard portfolio up to an amount equivalent to 250 percent of the capital and reserves of each institution. The cash proceeds from these sales were used to repay debts to the Central Bank or to buy specified central bank notes. Banks are not allowed to pay dividends on stock outstanding at the time of the sale of portfolio to the Central Bank until that portfolio has been repurchased at its original indexed value plus a real annual interest rate of 5 percent, except with regard to new contributions where a total of 30 percent of earnings can be distributed as dividends. This measure effectively helps the banks to distribute the losses resulting from the substandard portfolio over several years.

Initially, the purchase operations were expected to be completed by early 1986. However, after careful review by the Central Bank, the Superintendency of Banks and the IBRD staff of the portfolio of some of the banks, particularly those previously intervened, 1/ it now appears that additional purchases of portfolio would be needed through the end of 1986. These additional purchases, which could be the equivalent of some 2-3 percent of GDP, will be directed mainly to two large intervened banks. 2/ Such transactions (which do not constitute operating losses for the Central Bank) will be accommodated within the net domestic assets targets of the Central Bank. The operations entail an element of subsidy, based on an interest differential between the portfolio purchased by the Central Bank and the instruments sold by the Central Bank. The subsidy in 1986 is estimated at less than 0.1 percent of GDP. In response to the staff's concern about the impact of the extension of the scheme, the authorities indicated that any alternative to the proposed course of action would have an adverse impact on the Central Bank's operating position. In particular, since the Central Bank has guaranteed the deposits and most of the external debt of these banks, any possible liquidations would be very costly.

Legislation also has been enacted that enables the Government, if necessary, to recapitalize intervened banks directly up to 49 percent of their capital and reserves. The legislation limits the participation of the state in the capital of these banks to a period of five years and also provides for a government transfer to the Central Bank to cover the potential losses arising from these operations. This legislation has

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1/ In January 1983, several financial institutions were intervened by the Superintendency of Banks, without change in ownership, and are now being managed by publicly appointed administrators.

2/ In May 1986, regulations were approved that allow for the purchase by the Central Bank of substandard portfolio up to an amount equivalent to 350 percent of new capital contributions.

made it possible for two of the five previously intervened banks to be recapitalized and transferred to private sector management, and progress is being made in this regard with the remaining three. Meanwhile, existing bank legislation will be modified to strengthen the private financial system and to increase the supervisory powers of the Superintendency of Banks.

3. Wage policy

The Government sets wages for the general government civil servants and establishes a minimum wage. Other wages have been determined either by collective bargaining or individual agreements. The Government will continue to follow a restrained wage policy aimed at strengthening external competitiveness, raising the level of employment, and keeping inflation low. On that basis, a general government wage increase, averaging about 15 percent, was implemented in December 1985 and no further increase is intended before December 1986. The increase, which was lower than the rate of inflation in 1985, follows the practice of previous years of not fully compensating for past inflation.

4. External policies

a. Exchange rate and tariff policies

The authorities have made significant progress in improving the external competitiveness of the Chilean economy and thus helping to consolidate the gains in the balance of payments. The peso has continued to be depreciated daily on the basis of the difference between domestic inflation in the previous month and the external rate of inflation relevant for Chile, currently estimated at 0.35 percent a month in terms of U.S. dollars. This inflation estimate is being kept under review and the exchange rate will be modified as appropriate to ensure Chile's competitiveness. In the discussions, the Chilean authorities noted that the inflation rate relevant for Chile may increase beyond the above estimate because of the depreciation of the U.S. dollar vis-a-vis other major currencies and that a relevant measurement of competitiveness requires more complex calculations than those implicit in the effective exchange rate estimates. The Chilean authorities said that they will continue to monitor closely developments in the balance of payments, including changes in the terms of trade, the availability of financing, and developments in the foreign exchange market, in order to be in a position to adjust exchange rate policy if it should be needed to attain the external objectives of the program.

The authorities have indicated that the uniform tariff rate, which was reduced to 20 percent in 1985, will not be increased during the remainder of the program; they remain committed to maintaining the current trade system, which is virtually free from quantitative and other nontariff restrictions on imports.

b. Other policies on the exchange system

From early 1983 and until the beginning of the new adjustment program, a sizable spread developed between the official and parallel markets. The spread fluctuated between 6 percent and 25 percent, giving rise to a multiple currency practice subject to approval under Article VIII, Section 3. From July 1985 until September 1985 the spread fluctuated at somewhat over 10 percent, but it rose to 20 percent in October and early November. Subsequently, the spread has declined. In May 1986 the spread stood at about 3 percent, apparently reflecting the strengthened performance under the adjustment program.

Since August 1982 the Central Bank has subsidized debt service payments on debt outstanding as of that time. This subsidy gives rise to a multiple currency practice subject to approval under Article VIII, Section 3 in the case of direct payments abroad by the corporate sector. As discussed above, the authorities have taken significant measures to eliminate the subsidy and the progress made in this regard will be evaluated at the time of the next review of the program.

To ease the pressures on official international reserves, in March 1983 the authorities introduced a 120-day deferment period for import payments and also temporarily tightened regulations governing the sale of foreign exchange for specified invisible transactions so as to avoid unauthorized capital outflows. These restrictions have since been eased; all bona fide requests for foreign exchange that require central bank authorization including those for travel other than for tourism, are approved without delay. On December 11, 1985 the Central Bank authorized an increase in travel allowances to US$500 a trip to Latin America and to US$1,500 a trip to other destinations. Additional increases are scheduled for June and December 1986.

The 1986 program envisages that the minimum financing requirements for imports will be eliminated as scheduled by the end of 1986. The authorities will take into account the effect of the one time impact of this elimination in determining their foreign financing requirements for 1987 so as to avert any effect on net international reserves. The limitations on the sale of foreign exchange for tourism and the minimum financing requirement for imports continue to give rise to exchange restrictions subject to approval under Article VIII.

5. Balance of payments objectives

a. Prospects for 1986

The balance of payments prospects for 1986 now appear somewhat better than envisaged at the time of the previous review, reflecting both lower oil prices and lower international interest rates. As was noted above, the current account deficit is now projected to decline from US$1.3 billion in 1985 to US$1.18 billion in 1986 (compared with the indicative target of US$1.3 billion), or from 8.2 percent of GDP in

1985 to 7.1 percent in 1986. Because of substantially lower inflows of medium- and long-term capital, to be partly offset by higher short-term inflows, the overall balance of payments position is projected to improve by US$35 million over the indicative target of US$15 million, to a total surplus of US$50 million.

The program envisages an increase in the trade surplus from some US$790 million in 1985 to about US$950 million in 1986, an improvement of some US$115 million over the previous projection. The current projection is based on an average price of petroleum of US$16 a barrel during the period May-December 1986, which implies an average price of US$17 a barrel for the year. This price could produce direct savings of the order of US$160 million compared with the earlier projection; assuming a small increase in the volume of petroleum imports in response to the lower price and allowing for somewhat higher non-oil import demand by the private sector, net savings may be of the order of US$80 million. Exports are projected to improve by US$39 million over the previous projection because of a higher volume of copper exports which would be offset in part by somewhat lower prices. A summary of the main assumptions in the new projection is presented in Statistical Appendix Table 15.

Compared with 1985, net factor payments are projected to decline by US$60 million, as the decline in interest rates and the reduction in spreads agreed with commercial banks more than offset the impact of the postponement of part of interest payments from 1985 to 1986. Although interest rates came down in early 1986, interest payments are only slightly lower than originally projected because of the lag with which most interest is paid and because certain short-term interest payments had been underestimated earlier. The average lagged interest rates for 1986 are now projected at 9 percent for prime and 7.9 percent for LIBOR, compared with earlier projections of 9.5 and 8.7 percent, respectively. The deficit in other services is projected to be broadly the same as in the previous estimate.

Net capital inflows 1/ are now projected at about US$1,230 million, compared with US$1,315 million projected earlier, on account of lower net medium- and long-term capital inflows which are only partly offset by higher private short-term flows. Disbursements of project loans from multilateral development agencies are now expected to decline from the level recorded in 1985 and to fall short of initial projections by some US$110 million, mostly reflecting shortfalls in IDB credits. IDB disbursements will have to be held to a lower level in 1986 to allow for an increase in the ratio of domestic to foreign financing. Furthermore, a lower utilization of an industrial rehabilitation loan, reflecting high interest rates relative to rates for other loans for the final borrower has resulted in lower disbursements. World Bank disbursements are now expected to be slightly lower than initially programmed but still will

1/ Including errors and omissions registered in the first quarter.

show a significant increase. Projected disbursements include the second tranche of US$125 million under the first SAL from the IBRD and US$150 million from a proposed second SAL.

Disbursements of new money and cofinancing from commercial banks is assumed unchanged at US$371 million. Other bank lending, mainly financing related to foreign direct investment, is estimated at US$40 million and refinancing by official creditors is projected at US$66 million. In part because of a large transaction in the first quarter involving the purchase of a Chilean insurance company, direct investment is expected to exceed the original estimate by some US$80 million.

Short-term capital inflows in 1986 have been revised upward by some US$100 million, reflecting mainly the higher inflows in the first four months of the year mentioned above. Some of these flows, however, are expected to be reversed in response to the reduction in the interest rate premium paid by the Central Bank on swap operations and in the interest rate paid on dollar-denominated deposits.

b. Medium-term scenario

Over the medium term, a continuation of the policies embodied in the program would enable the authorities to continue to reduce the current account deficit further as a prerequisite for the achievement of a sustainable balance of payments position; debt service payments, while declining substantially in relative terms, will remain heavy and autonomous commercial bank lending can be expected to be limited. Accordingly, the scenario presented in Table 8 involves an expansion of foreign commercial bank exposure in Chile at an annual average of less than 2 percent, which can be viewed as appropriate in view of Chile's circumstances. 1/

Despite more favorable oil prices and interest rates, the targeted current account deficits after the program year, established at the time of the previous review, remain difficult to achieve and may require a more restrictive policy stance than envisaged at the time of the program inception. As pointed out in the previous review paper (EBS/86/20), tighter financial policies and a further change in relative prices may be needed to strengthen the increase in domestic savings and thus to make possible a politically and socially acceptable rate of growth. In view of the adjustment that is already being carried out, it would be possible to envisage somewhat higher levels of direct investment accompanied by a slower reduction in net borrowing requirements in the period beyond the expiration of the extended arrangement. When assessing Chile's debt burden, it should be noted that the scheme to purchase debt at a discount is contributing to a lower net growth of debt than originally foreseen. Accordingly, the staff has prepared the revised

1/ The increase in exposure, which is substantially less than envisaged in the Baker initiative, assumes that financing gaps after 1986 would be filled mostly through commercial bank borrowing.

Table 8. Chile: Balance of Payments--Medium-Term Projections, 1984-1990

	1984	1985	1986	1987	1988	1989	1990
			(In millions of U.S. dollars)				
Trade balance	293	788	955	1,105	1,314	1,543	1,784
Exports	3,650	3,743	4,053	4,450	4,979	5,594	6,286
Imports	-3,357	-2,955	-3,097	-3,346	-3,665	-4,050	-4,502
Nonfactor services and transfers	-398	-194	-293	-312	-343	-383	-432
Factor services	-1,955	-1,901	-1,844	-1,792	-1,852	-1,910	-1,952
Balance on current account	-2,060	-1,307	-1,181	-1,000	-880	-750	-600
Direct investment	67	112	187	169	173	185	200
Scheduled amortization	-1,507	-2,247	-2,723	-2,488	-3,175	-2,818	-2,476
Of which: to commercial banks	...	-1,983	-2,304	-2,069	-2,599	-2,105	-1,796
Capital inflows	3,418	3,446	3,769	3,350	3,882	3,433	2,926
Medium- and long-term	801	631	656	791	...	...	...
Short-term 1/	778	149	203	-76	...	...	...
Extraordinary financing	1,839	2,666	2,908	2,635 2/	...	...	...
Change in official reserves (increase -)	82	-4	-50	-30	—	-50	-50
			(In percent of GDP)				
Current account deficit	10.7	8.2	7.1	5.6	4.5	3.5	2.6
Interest payments on external debt	11.2	12.1	11.2	10.2	9.6	9.0	8.3
Total external debt outstanding at year end	95.9	119.4	116.7	113.9	106.8	99.7	91.7
			(In percent of exports)				
Current account deficit	45.8	29.1	24.8	19.2	15.1	11.5	8.2
Total debt service payments	81.6	97.7	107.9	88.6	89.2	72.3	60.2
Debt service payments after rescheduling	58.8	57.1	60.5	49.6	89.2	72.3	60.2
Of which: interest payments	48.8	43.2	39.5	34.7	31.9	29.2	26.5
Total external debt outstanding at year end	409.4	425.3	410.0	388.0	355.3	324.1	293.0

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

1/ Includes extraordinary amortization, valuation adjustment, and errors and omissions.
2/ Includes unidentified financing of US$505 million.

scenario of Table 8 to reflect a somewhat higher current account deficit but a lower rate of growth of external debt. Uncertainties associated with the projection of likely capital flows are high, however, and at this stage it is not possible to indicate with any precision the amounts available from all sources after 1986.

The revised scenario is consistent with the originally targeted current account deficit of US$1 billion for 1987. The assumptions underlying the projections are those of the most recent WEO exercise (Statistical Appendix Table 15) and would allow for an average annual increase in import volumes of 5.6 percent a year. Total external debt in relation to GDP would decline from 119 percent of GDP in 1985 to 92 percent in 1990. 1/

As the recent experience shows, Chile's balance of payments position is very vulnerable to external developments, and the targeted current account path described in Table 8 leaves limited margin for adverse developments. There are substantial uncertainties with regard to a number of key variables, such as copper and oil prices and interest rates. Table 9 summarizes the effects of changes in some of the assumptions with regard to the outcome presented in Table 8. Thus, if copper prices were to remain unchanged in real terms over the 1986-90 period, rather than increasing by 6 percent in real terms as assumed in Table 8, the average rates of growth of real imports would be reduced to 4.9 percent for a given current account outcome (Scenario B). If simultaneously international interest rates were to rise by 1 percentage point from present levels, the average rates of growth of real imports would be further reduced to 4.0 percent (Scenario C). Even more importantly, for each dollar the price of petroleum were to exceed the projection, non-oil imports would decline by 0.7 percent. On the other hand, if noncopper terms of trade were to regain their 1984 level, while copper and oil prices and interest rates are as assumed in the base scenario, there would be room for an annual average increase in import volumes of 6.3 percent (Scenario D). Of course, in such circumstances the improved conditions could be reflected in a lower current account deficit and thus in reduced net foreign borrowing.

6. External debt policies

Chile's total external debt at the end of 1985 was estimated at US$19.1 billion, or about 119 percent of GDP (Table 10). External debt is now projected to increase significantly less in 1986 than previously envisaged--to a level of US$19.5 billion--because of a lower current account deficit, higher purchases of debt at a discount and higher unregistered short-term capital inflows. Thus, in relation to GDP, total debt is projected to decline to 117 percent in 1986 rather than

1/ It should be noted that the debt ratios to GDP have been influenced by the larger than expected depreciation against the U.S. dollar. On the basis of the original program, total debt in relation to GDP would have fallen to 79 percent by 1990.

Table 9. Chile: Sensitivity Analysis of Medium-Term Scenario

	Program Scenario	Scenario B	Scenario C	Scenario D
Assumptions				
	(U.S. cents per pound)			
Copper prices - 1986	66.4	66.4	66.4	66.4
- 1990	84.0	79.2	79.2	84.0
	(Prime rate in percent)			
Foreign interest rates - 1986	9.0	9.0	9.0	9.0
- 1990	8.5	8.5	9.5	8.5
	(Annual rates of change, 1986-90)			
Noncopper prices	4.4	4.4	4.4	5.4
Outcome				
Real imports	5.6	4.9	4.0	6.3
	(In percent of exports of goods and nonfactor services)			
Debt service payments - 1986	107.9	107.9	107.9	107.9
- 1990	60.2	61.8	64.9	58.6
Interest payments - 1986	39.5	39.5	39.5	39.5
- 1990	26.5	27.2	30.3	25.8

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

Table 10. Chile: External Debt, 1982-86

	1982	1983	1984	1985 Prel.	1986 Prog.	1986 Rev. Prog.
	(In millions of U.S. dollars)					
Medium- and long-term debt outstanding end-period	13,815	14,832	16,963	17,787	18,455	18,039
International organizations						
Outstanding end-period	444	645	935	1,412	2,089	1,961
Drawings	(64)	(230)	(341)	(488)	(711)	(600)
Amortization	(22)	(24)	(34)	(38)	(45)	(51)
Interest payments	(33)	(39)	(59)	(117)	(155)	(158)
Official lenders 2/						
Outstanding end-period	770	790	614	833	691	844
Drawings	(--)	(105)	(--)	(61)	(60)	(48)
Amortization	(78)	(75)	(73)	(29)	(23)	(37)
Interest payments	(32)	(29)	(25)	(55)	(32)	(49)
Private banks and financial institutions						
Outstanding end-period	10,999	12,077	14,226 1/	14,518	14,793	14,257
Drawings	(2,206)	(1,468)	(1,086)	(793)	(521)	(435)
Amortization 3/	(823)	(439)	(127)	(452) 4/	(294)	(697) 4/
Interest payments	(1,517)	(1,186)	(1,560)	(1,345)	(1,366)	(1,298)
Other						
Outstanding end-period	1,602	1,320	1,187	1,024	881	978
Drawings	(323)	(145)	(165)	(128)	(147)	(218)
Amortization	(326)	(359)	(254)	(207)	(322)	(264)
Interest payments	(166)	(139)	(150)	(110)	(97)	(99)
Short-term debt outstanding end-period 5/	3,138	2,299	1,434 1/	1,342	1,501	1,498
Net drawings 5/	(349)	(-739)	(-865) 1/	(-92)	(104)	(156)
Interest payments 6/	(549)	(419)	(364)	(316)	(253)	(278)
Total debt outstanding end-period	16,953	17,131	18,397	19,129	19,956	19,537
Total amortization payments	1,248	660 7/	488	626 7/	633 7/	999
Total interest payments	2,290	1,814	2,158	1,943	1,903	1,882
Total debt service	3,547	2,474	2,646	2,569	2,536	2,881
	(In percent of GDP)					
Memorandum items						
Total external debt end-period	69.6	86.7	95.9	118.7	122.7	116.7
Interest payments on external debt	9.4	9.1	11.2	12.1	11.7	11.2
	(In percent of exports of goods and nonfactor services)					
Debt service payments after rescheduling	76.3	53.8	58.8	57.1	52.9	60.5
Interest payments	49.5	39.4	48.0	43.2	39.7	39.5
Total external debt outstanding at year-end	365.2	372.3	409.4	425.3	416.0	410.0

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

1/ Takes account of US$1,160 reclassified from short-term to long-term debt.
2/ Includes from 1985 ccc-guaranteed credits and other guaranteed credits eligible for rescheduling by official creditors. For previous years such credits are included under private banks and financial institutions.
3/ After refinancing.
4/ Includes estimated extraordinary amortization through purchase of debt at discount of US$206 in 1985 and US$539 in 1986.
5/ Excludes short-term liabilities of the Central Bank.
6/ Includes interest payable to the IMF and the BIS.
7/ Excludes amortization payments to Banco Andino as follows: 1983, US$236 million; 1985, US$100 million; and 1986, US$50 million.

increase to 123 percent as projected in EBS/86/22. Reflecting both higher scheduled and extraordinary amortization payments associated with the purchase of debt at a discount, debt service payments are projected to increase from 98 percent of exports of goods and nonfactor services in 1985 to 108 percent in 1986; interest payments, however, would decline from the equivalent of 43 percent to 39.5 percent. 1/

The external debt strategy formulated by the authorities is aimed at maintaining debt at a level that can be serviced in an orderly fashion; therefore, limits have been established on new medium- and long-term foreign borrowing, on the use of short-term debt, and on the extension of official guarantees on private external debt. Reflecting this policy and the substantial extraordinary amortization payments, the exposure of foreign commercial banks is projected to decline by 1.4 percent in 1986, while that of international organizations will increase by 39 percent. The exposure of other creditors is projected to remain broadly unchanged.

The Government in 1985 reached agreement to restructure principal payments falling due to commercial banks during 1985-87 and in securing additional new financing for 1985-86. 2/ The representatives of eight creditor governments 3/ on July 17, 1985 agreed to reschedule 65 percent of principal payments due during the period July 1, 1985-December 31, 1986 on Chilean public or publicly guaranteed debt with an original maturity of more than one year which had been extended directly, guaranteed, or insured by the participating creditors governments. Bilateral agreements were signed in early 1986. The debt relief from that restructuring was originally estimated to amount to US$170 million--US$67 million in 1985 and US$103 million in 1986. During the process of reconciliation of creditor and debtor data, it was discovered that some of the credits which had been included in the original base estimates were not subject to guarantee, reducing debt relief from this source to US$146 million.

The Government has made major efforts to assist the private sector in restructuring its external debt in the context of the rescheduling arrangement with foreign commercial banks. However, the Government is firmly committed not to guarantee any private external debt, except for the financial private sector amortization payments on debt outstanding

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1/ Excluding refinanced amortization payments, debt service payments are projected to increase from 57 percent of exports of goods and nonfactor services in 1985 to 61 percent in 1986.

2/ For a detailed description of the terms of the financing package with commercial banks, see EBS/85/122, Supplement 1, 7/12/85, pps. 7-10.

3/ The countries participating in the rescheduling agreement were Austria, France, Germany, Japan, the Netherlands, Spain, the United Kingdom, and the United States. The restructuring applied only to countries with respect to which amortization payments falling due during the reorganization period were at least SDR 1 million.

as of January 31, 1983, which were included in the restructuring agreements with foreign commercial banks concluded in early 1986.

To facilitate the reduction in Chile's external indebtedness, the Central Bank created in 1985 a mechanism permitting private resident and nonresidents to purchase, for specified uses in Chile, selected external claims on Chilean public and private debtors, provided that the foreign exchange would not be obtained in the official foreign exchange market. Through this mechanism, Chile has been able to benefit from the discount prevailing in secondary markets abroad for such instruments--about 30 percent. In the case of foreign direct investment, the investment is authorized by the Central Bank. The conversion of Chilean debt instruments for authorized transactions not involving foreign direct investment must also be channeled through Chilean financial institutions. For the later type of transactions, financial institutions are limited by a quota which is allocated by the Central Bank on the basis of auction system. 1/ The premia paid to the Central Bank in recent auctions amounted to about 10 percent of the face value of the obligations. The scope of the debt purchase mechanism was expanded in May 1986, by broadening the coverage of the qualifying external debt and the permissible domestic use of the assets or their proceeds in local currency. Previously, these assets could be used only to settle direct domestic debts or that of third parties, or to be exchanged for third party equity and fixed assets of financial institutions. Currently the domestic use of the debt or its local currency proceeds has virtually no limitations. The auction gives rise to a multiple currency practice which is confined to capital transfers. In the staff's view the system contributes to the exchange of foreign obligations into domestic obligations and therefore serves a useful purpose in Chile's current circumstances of high indebtedness.

From the inception of the purchase mechanism until April 1986, the monthly limit on transactions not involving foreign direct investment averaged about US$20 million a month. The limit was increased to US$30 million in May 1986 and to US$40 million effective July. Total operations by residents from the beginning of the program until March 31, 1986, amounted to US$183 million. Authorized purchases under the foreign investment provision amounted to US$91 million over the same period.

IV. Performance Criteria for 1986

As in the past, the economic program for 1986 includes the following quantitative performance criteria: (i) quarterly limits on the deficit of the nonfinancial public sector; (ii) continuous ceilings on the net domestic assets of the Central Bank; (iii) quarterly targets for the net international reserves of the Central Bank; (iv) limits on the

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1/ The auction is performed as a Dutch auction; on the basis of the established quota, the bidders pay the Central Bank the offered bid price.

stock of short-term external debt owed by the nonfinancial public sector and Banco del Estado (a state owned commercial bank); (v) a continuous ceiling on the public sector's (including the Central Bank and Banco del Estado) contracting and guaranteeing of foreign debt with a maturity of over one year but less than ten years, and a subceiling on such contracting with a maturity of over one year but less than five years; and (vi) a ceiling on rescheduling operations of the public sector or guaranteed by the public sector. The quantitative performance criteria are presented in Table 2.

The arrangement also continues to include as performance criteria the elimination of the minimum financing requirement for imports by end 1986 and successive increases in the travel allowance by June 1986 and December 1986. The authorities have already established a schedule with regard to the elimination of the preferential exchange rate subsidy on debts exceeding US$50,000. Debts with original value of less than US$50,000 that are eligible for the preferential exchange rate subsidy are likely to be paid by the end of the program period; approval of this practice is therefore proposed. The reductions of the general import tariff took place ahead of schedule. A review is envisaged before January 31, 1987, when the authorities will reach understandings with the Fund on the economic policies and performance criteria related to the year 1987. The review will focus in particular on the progress being made in eliminating the operating losses of the Central Bank and reducing swap related subsidies.

V. Staff Appraisal

The Chilean authorities have made considerable progress in achieving the objectives of the adjustment program that was initiated in 1985 and that has been supported by an extended arrangement from the Fund. The intensification of the adjustment effort under that program was necessary in light of Chile's high debt service burden and uncertain prospects for an improvement in Chile's terms of trade, and the authorities acted promptly to correct existing imbalances.

During 1985 Chile's economic performance showed a significant improvement. The external current account deficit narrowed in line with the projections of the program and the overall balance of payments showed a small surplus. The rate of inflation slowed down during the year and real GDP increased by 2.4 percent, led by growth in exports and capital formation. The economic situation continued to improve in early 1986 as economic activity increased, the rate of inflation continued to decline, and the balance of payments was stronger than expected. Chile has made all the purchases scheduled under the arrangement to date.

A key factor behind the positive results under the program has been the larger than originally projected reduction in the overall deficit of the nonfinancial public sector, reflecting both restrained expenditure policies and a stronger performance of the public sector enterprises. The fiscal effort was accompanied by a cautious monetary policy, and wage and exchange rate policies helped Chile to improve its competitiveness. In addition, major efforts were directed to reducing the subsidies granted through the financial system, thereby helping to contain the operating losses of the Central Bank. The adjustment also was aided by the completion of the external financing packages that include official creditors, multilateral agencies, and commercial banks.

While considerable progress has been made under the program to date, continuing efforts are required to consolidate the gains that have been made. It should be noted that the objectives of the program have been revised and quantitative targets have been tightened for the remainder of 1986 to incorporate the improved outlook for the Chilean economy, in reflection of the lower petroleum prices and interest rates in international markets and a strengthening of domestic confidence. However, existing uncertainties, particularly with regard to copper and petroleum prices, indicate the need for a close monitoring of economic policies to ensure that they remain appropriate.

The decline in world petroleum prices resulted in a deterioration of the profits from domestic production by the state petroleum company. Thus, even though the targets for the deficit of the nonfinancial public sector and public sector savings for 1986 remain broadly unchanged, a significant adjustment in petroleum taxes was necessary to ensure the achievement of these targets. With the new measures, the staff is of the view that the policy stance for the remainder of the year is adequate to achieve the plans for the nonfinancial public sector. However, the authorities should take every opportunity to consolidate further the adjustment effort. In this regard, the staff welcomes the intention not to allow increased expenditure should the petroleum tax produce additional revenues. Also, the authorities should prevent external financing shortfalls from exerting pressures on the domestic financial markets with detrimental effects on investment.

The authorities are committed to pursuing cautious monetary policies and have tightened their credit program. Of particular importance in the effort to achieve the aims of the credit plan has been the considerable progress made in reducing the operating losses of the Central Bank through the actions taken since 1985, which have been directed to the elimination of subsidies granted through the preferential exchange rate and interest rates on swaps. These actions also should help improve resource allocation over the longer run. Because some losses may arise on account of past operations, it will be necessary to monitor developments in this area quite closely, to be in a position to correct any emerging imbalances in the central bank finances. Also, care should be taken that any assistance given to improve the solvency of the financial system does not hamper the overall management of monetary policy.

The staff believes that the current exchange rate policy, supported by the wage policy being pursued, is appropriate for protecting the external competitiveness of the Chilean economy and achieving the objectives of the program. These policies should be continued notwithstanding the transitory improvements of external conditions.

Chile has made progress in reducing the rate of growth of its external debt and in improving its maturity structure. The completion of the restructuring arrangement with commercial banks and with official creditors has been a contribution in this regard. The mechanisms established in 1985 for the purchase of Chile's external debt at a discount also have helped to reduce the external debt, promote foreign direct investment, and bring back funds held by Chilean residents abroad. However, efforts will have to be intensified to reduce the dependence on foreign borrowing over the medium term, so as to make resort to concerted foreign financing unnecessary. The staff supports the authorities in their intention not to provide new guarantees on private sector debt.

Chile maintains a multiple currency practice arising from the use of a preferential exchange rate applicable to the servicing of some foreign debts. 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 gives rise to a multiple currency practice. In addition, Chile maintains exchange restrictions arising from the limitations placed on the sale of foreign exchange for tourism and from a 120-day deferment period on import payments.

The authorities have reiterated their intention to eliminate the existing exchange restrictions and multiple currency practices before the end of the period of the extended arrangement, and considerable progress has been made in this regard. The authorities have established a schedule for the elimination of the preferential exchange rate subsidy on virtually all foreign debt transactions. Moreover, in late 1985 they increased substantially the travel allowances for tourism, and the spread between the official and the parallel market rates has diminished. The authorities also maintain their commitment to eliminate the 120-day import financing requirements by end 1986. In view of the progress made toward eliminating these practices and of the current balance of payments situation, the staff proposes approval of the existing practices until the earlier of end-February 1987 or the midyear review of the second year program under the arrangement.

The staff believes that the policies pursued since the inception of the program have helped to strengthen Chile's economic performance. The revised program for 1986 appropriately tightens these policies in light of improved circumstances. The structural adjustment policies that are embodied in the program, together with the sustained pursuit of cautious demand management, will help foster growth and reduce the need for foreign borrowing. However, even under the currently improved circumstances of Chile, it will continue to be important to monitor developments closely and to be prepared to take further actions, if needed, to help achieve the program targets.

It is proposed that the next Article IV consultation with Chile take place on the regular 12-month cycle.

VI. Proposed Decisions

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

I. 1986 Consultation

1. The Fund takes this decision relating to Chile's exchange practices subject to Article VIII, Sections 2 and 3, in the light of the Article IV consultation with Chile conducted under Decision 5392 (77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Chile maintains multiple currency practices and exchange restrictions as described in EBS/86/137. The Fund welcomes the progress being made in eliminating these practices and restrictions. In view of the intentions of the authorities in this regard, the Fund grants approval for their retention until the earlier of February 28, 1987, or the conclusion of the midyear review of the second year program under the extended arrangement.

II. Extended Arrangement

1. Chile has consulted with the Fund in accordance with paragraph 4(c) of the extended arrangement for Chile (EBS/85/122, Supplement 3), paragraph 4 of the letter of July 9, 1985 from the Minister of Finance and the President of the Central Bank of Chile attached thereto, and paragraph 6 of the letter of January 20, 1986 (EBS/86/41), in order to establish suitable performance clauses for the second year of the arrangement.

2. The letter dated June 18, 1986 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 for Chile, and the letters dated July 9, 1985 and January 20, 1986, together with the respective annexed Memoranda on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated June 18, 1986, together with its annexed Memorandum on the Economic Policies of Chile.

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

(a) during any period in which the data at the end of the preceding calendar quarter indicate that the cumulative limits on the overall deficit of the nonfinancial public sector, as specified in paragraph 20 and Table 1 of the memorandum annexed to the attached letter of June 18, 1986, have not been observed, or

(b) during any period in which the continuous ceiling on the net domestic assets of the Central Bank of Chile, as specified in paragraph 21 and Table 2 of the memorandum annexed to the attached letter of June 18, 1986, is not observed, or

(c) during any period in which the data at the end of the preceding calendar quarter indicate that the target on the net international reserves of the Central Bank, as specified in paragraph 21 and Table 3 of the memorandum annexed to the attached letter of June 18, 1986, has not been met, or

(d) during any period in which the continuous ceiling on the stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado, as specified in paragraph 30 and Table 4 of the memorandum annexed to the attached letter of June 18, 1986, is not observed, or

(e) during any period in which the continuous ceilings or subceilings on the contracting and guaranteeing of medium- and long-term external debt by the public sector, or the continuous ceiling on the rescheduling of external debt by the public sector and by the private sector with the guarantee of the public sector, as specified in Table 5 of the memorandum annexed to the letter of January 20, 1986, are not observed, or

(f) during any period in which the understandings referred to in paragraph 31 of the memorandum annexed to the letter of January 20, 1986, are not being observed, or

(g) during any period after January 31, 1987 in which the midyear review contemplated in paragraph 5 of the attached letter of June 18, 1986, has not been completed, or while the understandings reached are not being observed.

4. Until July 14, 1987 purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 500 million provided that purchases shall not exceed the equivalent of SDR 250.00 million until August 15, 1986, the equivalent of SDR 312.50 million until November 14, 1986, the equivalent of SDR 375.00 million until February 13, 1987, and the equivalent of SDR 437.5 million until May 15, 1987.

Chile - Fund Relations
(As of May 31, 1986)

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 holding of Chilean pesos: SDR 1,509.1 million or 342.5 percent of quota as of May 31, 1986.

	Millions of SDRs	Percent of Quota
Of which:		
Under CFF	328.7	74.6
Credit tranche (SBA)	252.8	57.4
Extended Fund Facility	125.0	28.4
Enlarged access		
Under standby	237.0	53.8
Under EFF	125.0	28.4

(c) Fund credit to Chile amounts to SDR 1,068.6 million or 242.6 percent of quota.

III. Current Stand-by or Extended Arrangement and Special Facilities

(a) Extended arrangement:
(i) Duration: From August 15, 1985 to August 14, 1988
(ii) Amount: SDR 750 million
(iii) Utilization: SDR 187.5 million
(iv) Undrawn balance: SDR 562.5 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) Use of Compensatory financing facility in last 3 years:
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 May 31, 1986		
	Net cumulative allocation	121.9	100.0
	Holdings	2.7	2.2

B. Nonfinancial Relations

V. Exchange Rate Arrangement: The Chilean peso is pegged to the U.S. dollar. The official rate is adjusted daily on the basis of the Chilean rate of inflation during the previous month less the world rate of inflation relevant for Chile, currently estimated at 0.35 per month. The official rate on May 30, 1986 was *Ch$190.22 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 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 exchange restrictions arising from the limitations placed on the sale of foreign exchange for tourism and from a 120-day deferment period on import payments. The extended arrangement specifies that these latter two restrictions be removed by December 31, 1986.

VI. Last Consultation and Review: On July 15, 1985, the Executive Board concluded the 1985 Article IV consultation and approved in principle an extended arrangement with Chile. The text of the Board decision follows:

1. The Fund takes this decision relating to Chile's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1985 Article IV consultation with Chile conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Chile maintains multiple currency practices and exchange restrictions as described in EBS/85/122, Supplement 1. In view of the authorities' intentions to reduce their reliance on these multiple currency practices and exchange restrictions, the Fund grants approval for their retention through July 14, 1986 or the next Article IV consultation with Chile, whichever is earlier.

On February 28, 1986, the Executive Board completed the midyear review under the first year of the extended arrangement, including confirmation of understandings regarding policy intentions and objectives for 1986 and the specification of quantitative performance criteria for the period January 1 through June 30, 1986 (EBS/86/20 and Buff 86/40).

VII. Technical Assistance: A consultant provided by the Central Banking Department visited Santiago during March 1984 to review legislation on a national deposit insurance scheme. Another Central Banking Department consultant visited Santiago for three weeks in July/August 1985 to prepare a feasibility study for the introduction of an export credit insurance system in Chile.

The Bureau of Statistics provided a technical assistance mission to Chile on January 16-28, 1983. The mission assisted the Central Bank in converting its monetary data system to the new Fund data system. In August 1983 a representative of the Bureau of Statistics presented a seminar on improving the methodology for producing government finance statistics. A representative of the Bureau of Statistics visited Santiago in November 1984 and again in June 1985 to assist in revising the presentation of the monetary accounts.

VIII. Resident Representative: A resident representative has been stationed in Chile since November 1982. Mr. Chee Sung Lee replaced Mr. John Leimone in this post in February, 1986 for an initial period of one year.

STATUS OF WORLD BANK GROUP OPERATIONS IN CHILE

1. Statement of bank loans and IDA credits (as at March 31, 1986)

Loan or Credit Number	Fiscal Year	Borrower	Purpose	US$ million Amounts (less cancellations) Bank	IDA	Undisbursed
25 loans and one credit fully disbursed				402.6	22.9 1/	-
1832	1980	Chile	Water supply	32.4	-	4.2
2297	1983	Chile	Highway Reconstruction II	128.0	-	62.6
2481	1983	Chile	Agricultural credit	56.0	-	51.8
2482	1983	Chile	Housing	80.0	-	38.6
2504	1985	Chile	Public sector management	11.0	-	10.0
2589	1985	Chile	Road sector	140.0	-	128.0
2606	1985	Chile	Industrial financing restructuring	100.0	-	90.0
2613	1985	Chile	Small and medium industry	40.0	-	36.0
2625	1986	Chile	Structural adjustment	250.0	-	125.0
2651 2/	1986	EMOS	Water supply and sewer	60.0	-	60.0
2652 2/	1986	ESVAL	Water supply and sewer	6.0	-	6.0
Total				1,306.0	22.9	
of which has been repaid				230.6	4.5	
Total now outstanding				1,075.4	18.4	
Amount sold			7.2			
of which has been repaid			7.2			
Total now held by Bank and IDA				1,075.4	18.4	
Total undisbursed						612.2

1/ Includes exchange rate adjustments. The original amount of the credit was US$19.0 million.
2/ Approved but not signed.

2. Statement of IFC investments (as at February 28, 1986)

	Loan	Equity	Total
	(In millions of U.S. dollars)		
Total gross commitments	117.75	12.35	130.10
Less cancellations, terminations, repayments and sales	34.75	0.70	35.45
Total commitments now held by IFC	83.00	11.65	94.65
Total undisbursed	78.79	8.38	87.17

3. IBRD Disbursement forecast CY86-CY87

	CY86	CY87
Gross disbursements from approved loans, including SAL I	241.0	154.0
Gross disbursements from probable loans, including SAL II	150.0	105.0
Probable SAL III		100.0
Total gross disbursements	391.0	359.0
Amortization	25.0	43.1
Net disbursements	366.0	315.9

4. Recent IBRD technical assistance

Besides the usual assistance to the Ministry of Public Works and Chile's water companies to prepare bankable investment projects and sector programs, the IBRD is financing specific technical assistance to the Ministry of Housing and Urbanization to study and improve the present mortgage market and has financed a special unit linked to the Central Bank to review individual corporate "workouts" prepared for financially distressed firms before certifying them as eligible for new, medium-term loans. On March 14, 1985, the IBRD Board approved a US$11 million Public Sector Management Technical Assistance (TA) Loan for Chile. This loan was designed to help improve the public sector's decision making process, the efficiency of state enterprises, the statistical system, and to support specific studies required by the SAL program of the Bank. The loan has already supported two studies reviewing potential improvements in Chile's public sector administration and evaluating the country's export agency (PROCHILE).

5. IBRD views on the investment program

As part of the SAL operation, the IBRD reached an agreement with the Chilean Government to review the public investment program proposed in the yearly public budget. A World Bank public investment review was updated by a mission that visited Chile during April/May 1986. The mission concluded that, as in 1985, the 1986 public investment program includes high-return, well-justified projects, fully consistent with the Government's effort to accelerate exports and improve the efficiency of the economy. This is not surprising, since Chile's Planning Office, which reviews most investment proposals, has an excellent system of project analysis. The mission also supported new investments planned to expand mineral exports during 1986-1990, and has encouraged the Government to develop a special program to establish the infrastructure needed for private forestry investments which could lead to major increases in exports. The next review will take place in November 1986. Chile's excellent project analysis will be complemented by a public management system which would ensure consistency between macroeconomic, sectoral, and institutional objectives. The authorities have agreed to establish such a system once the results of a study financed by the Public Sector Management Technical Assistance Loan are known

6. Recent economic and sector missions

(a) Public Sector Investment Review Mission in February 1986. Input from the mission will be used for SAL preparation and appraisal as well as incorporated in statement given to IMF.
(b) Technical Education Review Mission in February/March 1986. Draft report pending.

Chile: Selected Economic and Financial Indicators, 1982-86

	1983	1984	1985 Prog. 1/	1985 Prel.	1986 Prog. Orig. 2/	1986 Prog. Rev.
(Annual percent changes, unless otherwise specified)						
National income and prices						
GDP at constant prices	-0.7	6.3	3.0	2.4	3.5	4.5
GDP deflator	26.6	14.3	33.9	32.8	19.9	21.7
Consumer prices (average)	27.2	19.9	29.0	30.7	20.0	20.2
Consumer prices (Dec.-Dec.)	23.1	23.0	25.0	26.4	18.0	18.0
External sector (on the basis of U.S. dollars)						
Exports, f.o.b.	3.3	-4.6	2.2	2.5	10.1	8.3
Imports, f.o.b.	-22.6	19.1	-11.0	-12.0	8.3	4.8
Non-oil imports, f.o.b.	-28.0	21.9	-15.4	-15.0	8.2	11.0
Export volume	3.1	4.2	6.0	9.2	5.5	4.3
Import volume	-14.6	20.1	-16.5	-11.4	4.3	5.4
Terms of trade (deterioration -)	9.8	-7.5	--	-5.4	0.5	4.4
Nominal effective exchange rate (depreciation -) 3/	15.8	2.9	-21.0	-16.4	...	...
Real effective exchange rate (depreciation -) 3/ 4/	6.0	-13.6	--	-27.3	--	--
General government operations						
Revenue	6.5	22.5	43.1	34.7	20.9	18.2
Total expenditure (excluding amortization)	10.0	24.1	39.5	35.3	15.8	14.4
Money and credit						
Net domestic assets 5/	59.8	112.1	115.0	137.7	57.2	58.8
Public sector	8.6	9.7	12.9	-1.7	-5.4	-6.4
Private sector	40.4	76.3	78.1	68.1	54.0	54.9
Money and quasi money	15.5	31.4	34.6	53.0	25.9	30.4
Interest rate (effective annual rate, short-term deposit rate)	27.9	26.1	...	31.6	...	...
Velocity (GDP/broad money)	2.8	2.6	...	2.3	...	2.3
(In percent of GDP)						
Public sector savings	-0.1	0.6	3.2	3.8	4.2	4.3
Overall public sector surplus or deficit (-)	-3.0	-4.3	-3.0	-2.6	-2.3	-2.2
Net domestic financing	4.0	1.6	1.6	-1.5	-2.2	-2.0
Net foreign financing	-1.0	2.7	1.5	4.1	4.5	4.2
Gross domestic investment	9.8	13.6	12.2	13.7	14.8	15.7
Gross national savings	4.4	2.9	5.1	5.5	6.8	8.6
Current account deficit (-)	-5.4	-10.7	-7.1 6/	-8.2 7/	-8.0	-7.1
Medium- and long-term public and private external debt (end of year)	75.0	88.2 7/	107.4	111.0	111.3	107.8
Debt service ratio (in percent of exports of goods and nonfactor services) 9/	53.8	58.9	58.9	57.1	53.0	60.5
Interest payments (in percent of exports of goods and services)	37.8	44.8	43.6	41.4	39.7	37.9
(In millions of U.S. dollars, unless otherwise specified)						
Overall balance of payments	-603.0	-82.0	--	4.0	15.0	50.0
Gross official reserves (months of imports f.o.b.) (end of year)	9.1	8.5	9.8	10.2	8.6	9.0
Gross official reserves (months of current payments)	4.2	4.0	4.8	4.9	4.3	4.5
External payments arrears (defaults) (end of year)	--	--	--	--	--	--

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

1/ As set forth in EBS/85/122 and Supplement 1.
2/ As set forth in EBS/86/41.
3/ At the end of the year.
4/ On the basis of consumer prices.
5/ In percent of liabilities to the private sector at the beginning of the period. Based on end-of-period actual exchange rates.
6/ GDP in dollars measured at program exchange rate; the actual real depreciation of the peso was larger than programmed.
7/ After interest rate deferral.
8/ Includes US$1.2 billion of short-term debt that was consolidated to a medium-term loan in early 1984.
9/ After rescheduling.

Chile: Summary of the 1986 Economic Program

I. Major Assumptions

1. Real GDP is expected to grow by 4 1/2 percent from 1985 to 1986.

2. The volume of copper exports is projected to increase by 1.6 percent while the volume of noncopper exports is projected to rise by 6.3 percent. The volume of imports is projected to increase by 5.4 percent.

3. Chile's average import prices are expected to decline by 0.6 percent. The average price of copper is projected at US$0.66 per pound compared with US$0.64 in 1985, while noncopper export prices are expected to rise by 4.3 percent. Under these assumptions, the terms of trade would improve by 4.4 percent.

4. For calculating Chile's interest payments in 1986, the U.S. prime lending rate is projected to average 9.0 percent a year and the LIBOR 7.9 percent a year.

5. Real financial assets held by the nonfinancial private sector (excluding the private social security funds) are projected to increase by 6.4 percent. Real financial assets held by the private social security funds are estimated to grow by 24 percent. The net domestic assets of the financial system are projected to increase (with respect to their 1985 base) by 24 percent. Credit to the private sector is expected to increase by 28 percent while credit to the public sector is expected to decrease.

II. Targets

1. The rate of inflation as measured by the December to December change in the consumer price index is expected to decline from 26.4 percent in 1985 to no more than 18 percent in 1986.

2. The current account deficit of the balance of payments is expected to decline from US$1,307 million in 1985 to US$1,181 million in 1986, while the trade surplus is projected to increase from US$788 million in 1985 to US$955 million in 1986.

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$50 million in 1986.

III. Principal Elements of the Program

1. Exchange rate policy

To help ensure the balance of payments and growth objectives of the program, the authorities will continue to implement a flexible exchange rate policy. During 1986, 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 0.35 percent a month.

2. Wage policy

The authorities intend to follow a policy of wage restraint, abstain from interfering with wage negotiations in the private sector, maintain flexible labor markets, and encourage labor mobility. Civil servants' nominal wages were increased by an average 15 percent in December 1985, and no further general wage increase will be granted before December 1986.

3. Fiscal policy

The program for 1986 envisages a reduction in the overall deficit of the nonfinancial public sector from 2.6 percent of GDP in 1985 to 2.2 percent of GDP in 1986. Public sector savings are projected to increase by the equivalent of about 0.5 percentage points of GDP in 1986 largely as a result of restraint in current spending. Public investment in 1986 would increase by the equivalent of 0.5 percentage points of GDP to 7.5 percent. The overall deficit of the public sector adjusted for net capital revenue (i.e., the financing requirement) is projected to decline from 3.2 percent of GDP in 1985 to 3.1 percent.

4. Monetary policy

a. Under the program the authorities have taken or will take action to: (i) reduce the quasi-fiscal subsidies of the Central Bank and thereby its operating losses; (ii) enhance the role of market forces in the determination of interest rates; (iii) strengthen the capital position of the intervened banks and the Central Bank; and (iv) improve financial legislation.

b. Specific central bank commitments for 1986 are to: (i) limit the domestic debt refinancing programs to existing commitments at the beginning of the year; (ii) abstain from expanding or renewing existing special short-term credit operations or establishing new ones; (iii) carry out the already announced schedule of reductions in the preferential dollar subsidy; and (iv) carry out a schedule for the elimination of the premium on interest rate on foreign exchange swap operations and foreign currency deposits by May 1987.

5. External debt policies

The main elements of the medium-term debt strategy of the authorities are: a positive rate of economic growth based on export expansion that would allow for the servicing of the 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.

6. Other external policies

Under the program the authorities will continue to carry out their intentions to (i) reduce the scope of the preferential exchange rate subsidy; (ii) eliminate, in the period covered by the extended arrangement, the remaining multiple currency practice on account of this subsidy; (iii) liberalize further the current restrictions on the sale of foreign exchange for tourism by raising travel allowances from present levels to the levels prevailing in December 1, 1982 in two steps to be implemented by June 1986 and December 1986; and (iv) eliminate the 120-day deferment period for import payments by December 31, 1986. These intentions are performance criteria under the program.

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 1985 Goverment Finance Statistics Yearbook contains data through 1984 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

Information recently received from the Central Bank of Chile include data for July through October 1985 for the Central Bank that incorporate the recommended changes in compilation procedures made during the June 1985 technical assistance mission. These data will be shown in the July 1986 issue of IFS. 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 1986 issue of IFS. During the past year the data have been provided on a timely basis.

Status of IFS Data

		Latest Date in June 1986 IFS
Real Sector	National Accounts	1983
	Prices: Home and Import Goods	February 1986
	Home Goods	February 1986
	Consumer Prices	February 1986
	Production: Manufacturing	December 1985
	Mining	November 1985
	Employment	n.a.
	Earnings	Q1 1985
Government Finance	Deficit/Surplus	1984
	Financing	1984
	Debt	n.a.
Monetary Accounts	Central Bank	June 1985
	Deposit Money Banks	June 1985
	Other Financial Institutions	n.a.
External Sector	Merchandise Trade: Value	December 1985
	Unit Value: Copper Exports	November 1985
	Copper Exp. (wholesale price)	April 1986
	Import prices (in pesos)	February 1986
	Balance of Payments	1984
	International Reserves	April 1986
	Exchange Rates	April 1986

CHILE--Basic Data

Area and population	
Area	756,626 sq. kilometers
Population (1985 Prel.)	12.0 million
Annual rate of population increase (1980-85)	1.7 percent
Unemployment rate (Oct.-Dec. 1985)	11.9 percent
GDP (1985)	SDR 15,627 million
	US$16,018 million
	Ch$2,576,638 million
GDP per capita (Prel. 1985)	SDR 1,305

Origin of GDP	1982	1983	1984	Prel. 1985
		(percent)		
Agriculture, forestry, and fishing	9.3	9.2	9.3	9.6
Mining and quarrying	9.0	8.9	8.7	8.7
Manufacturing	19.3	20.0	20.7	20.4
Construction	5.4	5.2	5.1	5.8
Commerce	17.6	17.1	16.9	16.7
Other	39.4	39.6	39.4	38.8
Ratios to GDP				
Exports of goods and services	21.2	24.3	25.0	29.3
Imports of goods and services	31.1	30.2	36.3	37.9
Current account of the balance of payments	-9.5	-5.4	-10.7	-8.2
General government revenues	37.4	31.7	31.9	31.6
General government expenditures	39.7	34.7	35.5	35.3
Public sector savings	-0.8	-0.1	0.6	3.8
Public sector overall surplus or deficit (-)	-3.4	-3.0	-4.3	-2.6
External public debt (end of year)	26.5	40.9	61.7 1/	83.7
Gross national savings	1.8	4.4	2.9	5.5
Gross domestic investment	11.3	9.8	13.6	13.7
Money and quasi-money (end of year)	38.6	35.4	38.3	43.1
Annual changes in selected economic indicators				
Real GDP per capita	-15.5	-2.4	4.6	0.8
Real GDP	-14.1	-0.7	6.3	2.4
GDP at current prices	-2.7	25.7	21.5	36.1
Domestic expenditures (at current prices)	-10.1	20.0	26.3	30.9
Investment	(-51.6)	(9.3)	(68.8)	(36.9)
Consumption	(0.6)	(21.4)	(21.5)	(30.0)
GDP deflator	13.3	26.6	14.3	32.8
Consumer prices (annual averages)	9.9	27.2	19.9	30.7
General government revenues	4.3	6.5	22.5	34.7
General government expenditures	20.7	10.0	24.1	35.3
Money and quasi-money	10.9	15.5	31.4	53.0
Money	(7.4)	(27.6)	(12.0)	(11.3)
Quasi-money	(11.7)	(13.0)	(35.9)	(60.9)
Net domestic assets of the financial system 2/	68.6	59.8	112.1	137.7
Credit to nonfinancial public sector (net)	(14.0)	(8.6)	(9.7)	(-1.7)
Credit to private sector	(70.4)	(40.4)	(76.3)	(68.1)
Merchandise exports (f.o.b., in U.S. dollars)	-3.4	3.3	-4.6	2.5
Merchandise imports (f.o.b., in U.S. dollars)	-44.1	-22.6	19.1	-12.0

General government finances	1982	1983	1984	1985
	(billions of Chilean pesos)			
Revenues	463.5	493.7	604.8	814.4
Expenditures	491.8	541.2	671.6	908.6
Current account surplus or deficit (-)	-24.2	-44.2	-38.0	-24.3
Overall surplus or deficit (-)	-28.3	-47.5	-66.8	-94.2
External financing (net)	-4.2	-1.8	14.2	78.8
Internal financing (net)	32.5	49.3	52.6	15.4
Balance of payments	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	3,706	3,827	3,650	3,743
Merchandise imports (f.o.b.)	-3,643	-2,818	-3,357	-2,955
Investment income (net)	-1,921	-1,703	-1,955	-1,901
Other services and transfers (net)	-446	-379	-398	-194
Balance on current and transfers accounts	-2,304	-1,073	-2,060	-1,307
Official capital (net) 3/	823	1,260	1,634	1,185
Private capital (net)	192	-873	156	310 4/
Errors and omissions	-76	45	107	-132
Allocation of SDRs	--	--	--	--
Valuation adjustment	-28	38	81	-52
Change in net official reserves (increase -)	1,393	603	82	-4 5/

International reserve position 7/	Dec. 31 6/ 1983	1984	1985
	(millions of SDRs)		
Central Bank (gross)	2,034.6	2,418.8	2,283.6
Central Bank (net)	1,168.3	1,132.6	985.8
Rest of banking system (net)	-729.1 8/	-52.8 8/	-224.8

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 actual 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/ Excludes position of banks liquidated in January 1983. Net amounts excluded are SDR -37.7 million on December 31, 1983, SDR 19.2 million on December 31, 1984, and SDR 18.8 million on December 31, 1985.

Table 11. Chile: Performance under the Economic Program for 1985 1/

	Mar. 31 2/	June 30 2/	Sept. 30	Dec. 31
(In billions of Chilean pesos)				
Net domestic assets of the Central Bank 3/				
Limit	326.5	374.0	421.7	463.6
Actual	315.3	367.8	403.8	448.2 4/
Margin	11.2	6.2	17.9	15.4
Outstanding indebtedness of the nonfinancial public sector 5/				
Limit	926.1	987.7	1,052.7	1,127.0 6/
Actual	924.4	987.1	1,048.9	1,115.6
Margin	1.7	0.6	3.8	11.4
(In millions of U.S. dollars)				
Net international reserves of the Central Bank 5/				
Target	690	477	756 7/	1,111
Actual	797	516	354	1,116 4/
Deviation	107	39	-411	5
Stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado				
Limit	910 3/	910 3/	910 3/	890 5/
Actual	899	873	898	868
Margin	11	37	12	22
Contracting and guaranteeing of foreign debt by the public sector 3/				
A. With maturity of 1 to 10 years				
Ceiling	650	650	650	650
Actual	41	198	210	237
Margin	609	452	440	413
B. With maturity of 1 to 5 years				
Subceiling	250	250	250	250
Actual	9	123	110	111
Margin	241	127	140	139
C. Refinancing and rescheduling operations				
Ceiling	1,900	1,900	1,970	1,970
Actual	280	584	926	1,554
Margin	1,620	1,316	1,044	416

Source: Central Bank of Chile.

1/ For purposes of the program foreign currency transactions are converted at Ch$130=US$1 for the period January-March, at Ch$138=US$1 for the period April-June, at Ch$145=US$1 for the period July-September, and at Ch$155=US$1 for the period October-December.

2/ Indicative limits prior to program approval.

3/ Tested on a continuous basis.

4/ 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, expected to occur by June 1986.

5/ Tested at end of period.

6/ Incorporates an adjustment for emergency financing related to the March 1985 earthquake reconstruction effort amounting to Ch$1.1 billion.

7/ Target for September 30, 1985, which assumed the disbursement of US$440 million in new money from foreign banks by that date. Noncompliance was waived for that date.

Table 12. Chile: Operations of the Consolidated Nonfinancial Public Sector

(In billions of Chilean pesos)

	1982	1983	1984	1985 Prog.	1985 Prel.	1986 Prog. Orig.	1986 Prog. Rev.
General government current revenue	371.0	431.4	544.1	769.7	737.1	874.8	878.6
Taxes on income and property	71.0	77.8	88.1	84.9	94.8	142.1	124.6
Taxes on goods and services	167.5	211.0	270.8	388.9	388.6	462.4	493.5
Taxes on international trade	17.9	36.4	62.2	131.0	93.9	111.4	103.8
Social security tax	40.4	43.7	53.1	63.9	62.4	75.7	77.3
Other tax (net of IVA rebate)	-14.8	-19.3	-24.3	-28.8	-42.8	-55.1	-61.2
Nontax revenue	89.0	81.8	94.2	129.8	140.2	138.3	140.6
Operational surplus of the public enterprises	101.9	178.7	205.8	329.7	369.4	447.2	448.6
Of which: Codelco	30.7	67.1	57.8	114.1	147.9	175.3	199.1
ENAP	43.5	73.6	94.2	151.2	145.6	173.0	147.2
Net transfers of public enterprises 1/	-87.8	-135.3	-156.3	-241.5	-246.2	-326.7	-322.8
General government current expenditure	395.2	475.6	582.1	773.1	761.4	861.0	863.0
Wages and salaries	96.7	103.7	122.0	145.4	150.5	171.3	171.4
Goods and services	41.2	50.3	64.3	76.9	82.7	87.4	88.2
Social security payments to private recipients	133.5	150.3	191.7	253.0	232.2	274.7	276.9
Transfer and subsidy payments to private sector	112.1	138.2	154.7	224.1	205.9	246.8	244.1
Interest on public debt	6.8	27.7	45.1	70.4	83.0	75.0	76.7
Other	4.9	5.4	4.3	3.3	7.0	5.8	5.7
Current account surplus of the public sector	-10.1	-0.8	11.5	84.8	98.9	134.2	141.4
Net capital revenue 2/	26.0	27.7	19.5	25.3	14.9	35.7	31.0
Revenue	96.6	60.8	64.1	73.7	84.9	100.8	100.1
Less: financial investment 3/	-70.6	-33.1	-44.6	-48.4	-70.0	-65.1	-69.1
Capital formation	57.8	74.1	113.1	189.5	180.8	243.8	244.3
General government	26.1	33.0	42.9	88.0	79.9	111.5	108.7
Public enterprises	31.7	41.1	70.2	101.5	100.9	132.3	135.6
Overall surplus or deficit (-)	-41.9	-47.2	-82.1	-79.4	-67.1	-73.9	-71.9
Financing	41.9	47.2	82.1	79.4	67.1	73.9	71.9
External	27.8	-15.2	50.8	37.9	106.3	143.7	137.1
Internal	14.1	62.4	31.3	41.5	-39.2	-69.8	-65.2
Memorandum items							
Nominal GDP (in billions of Chilean pesos)	1,239	1,558	1,893	2,625	2,577	3,192	3,277
Overall balance adjusted for net capital revenue	67.9	76.4	102.5	104.7	81.9	109.6	102.9
Total revenue	411.1	502.5	613.1	883.2	875.1	1,031.0	1,035.4
Total expenditure	453.0	549.7	695.2	962.6	942.2	1,104.9	1,107.3

Sources: Ministry of Finance; and Central Bank of Chile.

1/ Includes tax payments and transfers of profits by the public enterprises already incorporated into general government revenues.
2/ Net capital revenue includes the net sale of assets by the public social security funds, which are in the process of being liquidated, as well as sales of shares in the public enterprises described in the text.
3/ Excludes net lending by CORFO and INDAP up to program limits in conjunction with special lending programs of the IDB and IBRD.

Table 13. Chile: Summary Quarterly Operations of the Consolidated Nonfinancial Public Sector

(Percent of GDP)

	1985				1986
	I	II	III	IV	I
Current revenue	7.1	8.0	8.5	9.8	7.3
General government	6.4	7.0	7.3	7.9	6.4
Operational surplus of the public enterprises	2.6	3.6	3.5	4.7	2.8
Net transfers to the general government	-1.9	-2.6	-2.3	-2.8	-1.9
Current expenditure of the general government 1/	6.7	7.2	7.5	8.2	6.2
Current account	0.4	0.8	1.0	1.6	1.1
Net capital revenues	-0.1	0.5	0.2	-0.1	—
Revenue	0.5	1.0	0.9	0.8	0.7
Less: financial investment 2/	-0.6	-0.5	-0.7	-0.9	-0.7
Capital formation	1.4	1.6	1.8	2.2	1.5
Overall surplus or deficit	-1.1	-0.3	-0.6	-0.7	-0.4
Memorandum items					
Overall financing requirement	1.0	0.8	0.8	0.8	0.4
Nominal GDP	2,577	2,577	2,577	2,577	3,277

Sources: Ministry of Finance; and Fund staff estimates.

1/ Includes monetary correction as part of interest payments.
2/ Excludes lending by CORFO and INDAP up to program limits in conjunction with special lending programs of the IDB and IBRD.

Table 14. Chile: Balance of Payments, 1985-86

(In millions of U.S. dollars)

	1985				1986 1st Quarter	
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Prelimi-nary	Program
Current account	-398	-335	-381	-193	-376	-440
Trade balance	179	229	167	214	312	217
Exports	(932)	(951)	(891)	(968)	(979)	(1,005)
Copper	/377/	/433/	/426/	/534/	/403/	/398/
Other	/555/	/518/	/465/	/435/	/576/	/607/
Imports	(-753)	(-722)	(-724)	(-754)	(-667)	(-788)
Nonfinancial services	-38	-63	-85	-69	-63	-80
Financial services	-549	-523	-476	-353 1/	-635	-587
Transfers	10	22	13	16	9	9
Capital account	171	-5	302	1,026	153	254
Direct investment	20	35	5	52	62	17
Scheduled amortization	-382	-515	-569	-781	-589	-607
Extraordinary amortization 2/	-19	-37	-88	-62	-184	-52
Medium- and long-term disbursements	120	87	260	165	104	138
Nonfinancial public sector	(94)	(62)	(227)	(102)	(69)	(86)
Of which: IBRD and IDB	/51/	/42/	/200/	/71/	/55/	/73/
Private sector 3/	(26)	(26)	(33)	(63)	(35)	(52)
Change in medium- and long-term assets 4/	31	20	79	43	119	47
Short-term capital	92	62	95	67	93	50
Nonfinancial public sector	(61)	(-24)	(15)	(-16)	(9)	(20)
Private sector 3/ 5/	(31)	(86)	(81)	(82)	(85)	(30)
Commercial credits	10	-63	85	17	-116	7
Extraordinary financing	299	406	435	1,526	665	655
Refinancing of maturities due	(299)	(406)	(435)	(688)	(512)	(502)
IBRD Structural adjustment loan	(--)	(--)	(--)	(125)	(--)	(--)
New money and co-financing loan	(--)	(--)	(--)	(714)	(153)	(153)
Errors and omissions	-60	62	-90	-43	111	--
Overall balance of payments	-287	-278	-169	790	-113	-186
Valuation adjustment of official reserves	-28	-3	-2	-19	13	--
Change in official reserves (increase -)	-315	-281	-171	771	100	-186

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

1/ Includes interest savings of US$140 million from change in interest payment date (part of the 1985-86 financial package).
2/ Prepayment of debt through purchases abroad of Chilean external debt at a discount; counter entries are made under change in medium- and long-term assets (Article XVIII) as direct investment (Article XIX).
3/ Includes Banco del Estado.
4/ Includes counter entry for prepayment of debt (Article XVIII).
5/ Includes counter entry for net tourist expenditures financed in the parallel market.

Table 15. Chile: Assumptions Underlying Medium- and Long-Term Scenarios

	1985	1986	1987	1988	1989	1990
	(U.S. cents per pound)					
Copper prices						
At current prices	64.3	66.4	71.0	75.5	79.5	84.0
At constant 1984 prices 1/	63.7	57.7	59.0	60.0	60.5	61.2
	(Thousands of metric tons)					
Volume of copper exports	1,353	1,375	1,400	1,466	1,564	1,664
CODELCO	1,074	1,086	1,100	1,160	1,263	1,363
Other	279	289	300	306	301	301
	(Annual change in percent)					
Noncopper export prices	-11.3	4.3	4.0	4.5	4.5	4.5
Noncopper export volume	8.7	6.3	6.5	7.5	7.5	7.5
Total export price	-6.3	3.8	5.3	5.3	4.9	5.0
Total export volume	8.9	4.3	4.3	6.2	7.1	7.0
Import prices	-0.7	-0.6	2.3	4.5	4.5	4.5
Import volumes 2/	-11.4	5.4	5.6	4.8	5.7	6.4
Terms of trade	-5.4	4.4	2.9	0.8	0.3	0.5
	(Payable in period; in percent)					
Interest rates						
Prime	9.9	9.0	8.5	8.5	8.5	8.5
LIBOR (180 days)	10.1	7.9	7.0	7.0	7.0	7.0
	(Annual change in percent)					
Memorandum items						
World trade unit values						
Manufactures	1.0	14.0	4.5	4.5	4.5	4.5
Petroleum	-4.4	-40.0	-6.3	4.5	4.5	4.5
Non-oil primary commodities	-12.2	3.8	-0.4	3.7	3.7	3.7
Partner countries' demand for non-oil imports	5.2	7.0	5.9	...	...	...

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

1/ Deflated by world trade unit values for manufactures.
2/ The value of imports is calculated as a residual on the basis of the current account target.

Santiago, Chile
June 18 , 1986

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
700 19th St., N.W.
Washington, D.C. 20431

Dear Mr. de Larosiere,

1. Since 1985, Chile has been pursuing a medium-term economic adjustment program that was described in our letter to you of July 9, 1985, when we requested the support of the International Monetary Fund in the form of a three-year extended arrangement. The economic policies that Chile intended to implement over the period of the arrangement were described in the economic policy memorandum attached to that letter and were reiterated in our letter and attached memorandum dated January 20, 1986.

2. We are writing at present to inform you about the progress achieved in the implementation of the economic program. We also wish to communicate to you our policy intentions for the second year of the program, and the quantitative targets and ceiling for the remainder of 1986.

3. During 1985 and early 1986 Chile made considerable progress in achieving the objectives of the economic program. The quantitative targets and limits for the third quarter of 1985 were observed, with the exception of the net international reserves target for end-September, and a waiver was granted for its nonobservance in November 1985. All quantitative performance criteria for the fourth quarter of 1985 and the first quarter of 1986 have been observed and all purchases available to Chile to date have been made.

4. While the external prospects for Chile have improved somewhat with regard to those envisaged at the time of the most recent review, considerable uncertainties exist with respect to some of Chile's main export products, mainly copper. Moreover, the domestic recovery is still modest and considerable additional efforts are required to achieve a sustainable external position. Accordingly, for the second year of the arrangement a continuation of those policies implemented since the approval of the extended arrangement, as described in the letters of July 1985 and January 1986 is proposed. The Government of Chile believes that the policies described in the attached Memorandum on the Economic Policies of Chile are adequate to achieve the objectives of the program.

5. During the remaining period of the extended arrangement, the authorities of Chile and the Fund will consult periodically, in accordance with the policies of the Fund on such consultations, about the progress being made in the implementation of the program described in the attached memorandum and the policy adaptations considered to be appropriate for the achievement of its objectives. With respect to the program for the second year, the authorities will review the implementation of policies, in particular those aimed at the operating losses of the Central Bank, and will reach understandings with the Fund before January 31, 1987 on the policies relating to the second half of the second year program. Also, before July 14, 1987 the authorities will reach understandings with the Fund on the economic policies relating to the third year of the extended arrangement.

Yours truly,

Enrique Seguel
President
Central Bank of Chile

Hernan Buchi Buc
Minister of Finance

Attachment

Memorandum on the Economic Policies of Chile

1. Considerable progress has been achieved in the recent past in creating the conditions for an improvement in the performance of the Chilean economy, which suffered a setback in 1984 in the wake of the sharp declines in copper prices and increases in foreign interest rates that, together with a rapid increase in demand, had resulted in a weakening of the current account and an increase in the already existing heavy debt burden. The Government responded to the deteriorating conditions by introducing an economic program initially covering the period 1985-87. The policies put in place were designed to narrow the external current deficit, thereby reducing Chile's reliance on foreign financing, by fostering growth in exports and domestic savings. In addition, the program sought to provide for a sustained expansion in economic activity and a decline in the rate of inflation.

2. The program was supported by an extended arrangement from the Fund. The Chilean authorities also obtained the support of the IBRD in the form of a structural adjustment loan, and completed a financing package for 1985-86 with foreign commercial banks and official creditors.

3. The program originally aimed at lowering the external current account deficit from US$2.1 billion in 1984 to US$1.4 billion in 1985 with further declines in subsequent years. The program also aimed at achieving an overall balance of payments equilibrium in 1985 and an accumulation of reserves of US$80 million over the program period, while reducing the rate of inflation to some 25 percent in 1985 and lower levels in subsequent years.

4. Performance under the program in 1985 was encouraging. During the year, Chile observed all the indicative targets and limits established for dates preceding the approval of the extended arrangement. The quantitative targets and limits for the third quarter also were observed, except for the net international reserves target for end-September, which was not met because of delays in the disbursement under the new money facility from commercial banks. The delay led to the postponement of the increase in travel allowances--a performance criterion under the program--to December 1985. A waiver was granted for the nonobservance of these performance criteria in November 1985. All quantitative performance criteria for December 1985 were observed.

5. Chile also was successful in achieving the objectives of the economic program in 1985, notwithstanding the adverse impact of a major earthquake that affected the country in March of that year. Economic activity was somewhat stronger than the 1.5 percent projected in December 1985, as real GDP grew at an annual rate of 2.4 percent, reflecting a level of gross capital formation and export volumes (particularly for non-copper products) in excess of those envisaged. Moreover, domestic savings strengthened considerably, in line with the program. The rate of inflation for the year, which reached 26.4 per-

cent, was slightly above the program target, but had slowed down significantly in the fourth quarter of the year.

6. A major factor in the adjustment effort was the marked improvement in the public finances. The overall deficit of the nonfinancial public sector was reduced from 4.4 percent of GDP in 1984 to some 2.6 percent in 1985, 0.5 percentage points below the original program objective. The reduction in the public sector deficit reflected continued restraint in expenditure, notwithstanding the earthquake reconstruction effort, reinforced by specific adjustment measures introduced in May 1985. While revenues were lower as a percentage of GDP than in 1984, they were nonetheless higher than envisaged earlier because of somewhat higher value added tax collections, related to the stronger GDP performance. More importantly, larger than expected copper shipments by CODELCO in the second half of the year sharply improved the public sector finances.

7. Monetary policy remained prudent, in line with the balance of payments and price objectives. Financial savings grew rapidly in real terms, because of the strong performance of the private social security funds and of a higher demand for financial assets by the rest of the private sector, reflecting their increased confidence in the financial system. While financial savings rose, currency in circulation increased less than projected and the Central Bank held net domestic assets below the programmed ceilings, thereby helping to achieve the reserve target for the year. Net international reserves, which had declined by over US$80 million in 1984, rose by some US$5 million, whereas no change had been envisaged. In line with its commitments, the Central Bank abstained from introducing new or expanding existing selective credit and debt refinancing programs; moreover, it started to reduce and phase out the preferential exchange rate and swap subsidies, thereby creating the conditions for a sharp reduction in the operating losses of the Central Bank in 1986. The credit restraint was attained notwithstanding the continuing efforts to strengthen the private financial system.

8. Although export prices weakened, the current account of the balance of payments improved considerably in 1985 in response to the tight demand management and the flexible exchange rate policy pursued, as well as by the reduction in interest rates in foreign financial markets. Accordingly, the current account deficit declined from US$2.1 billion in 1984 to US$1.3 billion in 1985, reflecting mostly an improvement of US$0.4 billion in the trade balance, a reduction in net nonfinancial service payments of US$0.2 billion, and some net savings in interest payments.

9. Overall capital flows performed broadly in line with original expectations, with lower medium- and long-term capital inflows being offset by higher short-term private sector flows, that reflected in part capital repatriation. The capital account was also strengthened by the significant progress made by Chile in restructuring its external debt and in securing new financing from multilateral, bilateral, and commercial sources. The completion of the external financing package also

contributed significantly to the improvement of the foreign exchange position of the Central Bank, after it had declined earlier in the year.

10. The pursuit of a realistic exchange rate policy has strengthened Chile's external performance. The peso depreciated substantially in real terms, by 12 percent in 1984, by 22 percent in 1985, and by a further estimated one percent in the first quarter of 1986, to the most depreciated level observed in recent years. The improvement in external conditions, the strengthening of competitiveness, and the increased confidence have helped in reducing the spread between the official and the parallel market exchange rates since late 1985.

11. During the first months of 1986, Chile's economic performance continued to improve in response to the continuing effect of the program policies and somewhat more favorable external conditions, most notably the drop in the world price of petroleum. In the first quarter of the year the current account of the balance of payments showed a deficit of US$380 million, compared with US$440 million projected at the time of the most recent review. The improvement reflected a broadly-based decline in the level of imports, while exports were generally in line with projections. The capital account has strengthened due largely to private sector capital flows, which responded to the improved economic conditions and a somewhat slower decline in domestic interest rates vis-a-vis foreign rates. In addition, the new money and cofinancing loans from commercial banks were disbursed in March 1986 as expected. On the basis of these developments the net international reserves were some US$90 million above target at the end of March, although still showing a decline of US$100 million since the beginning of the year. Meanwhile, economic activity has shown signs of significant strength on account of increased industrial and agricultural production in the first quarter of the year. In turn, inflation was 6.6 percent during the first four months of 1986, well below the rate of 10.6 percent observed in the same period of 1985. While the decline reflected in part some pass-through of the reduction in petroleum prices, it also reflected the cautious demand and wage policies.

12. The public sector finances improved during the first quarter of the year, with the nonfinancial public sector deficit having amounted to Ch$14.2 billion, or the equivalent of 0.4 percent of GDP. The improvement was in line with the financial program established previously, and took place notwithstanding the weakening of the finances of the petroleum company (ENAP) described below. Current expenditure was broadly in line with the program estimates, but revenues were significantly higher than expected, mainly because of improved economic activity, and notwithstanding lower tariff revenues because of lower levels of imports. On this basis, public sector savings were the equivalent of 1.2 percent of GDP, or 0.3 percentage points of GDP better than expected, and were fully reflected in a lower public sector deficit.

13. In 1986 monetary policy has continued to be carried out with caution and the net domestic assets of the Central Bank have been held

below their ceiling, as the Central Bank has sterilized short-term capital inflows, thereby strengthening the reserve position. Monetary aggregates have moved broadly in line with nominal GDP. Meanwhile, interest rates on peso instruments have declined in real terms by about 1.5 percentage points since the end of 1985, consistent with the decline in interest rates in international capital markets.

14. The prospects for the remainder of 1986 have generally improved reflecting increased confidence and improved external conditions, mainly lower petroleum prices and interest rates. However, considerable uncertainties exist with regard to certain specific areas. In particular, the behavior of copper prices in international markets is projected to be weaker than originally envisaged. In addition, some of the gains observed in petroleum prices could disappear in the months ahead. Within this context, the Chilean authorities are determined, and actions have already been taken, to strengthen the adjustment process and to continue pursuing the required structural adjustment policies needed to achieve the objectives of the economic program initiated in 1985 and described in our letters of July 1985 and January 1986. It is only through a firm pursuit of these policies that sustained economic growth, increased savings, and a reduced reliance on foreign borrowing can be achieved.

15. The projections of economic performance in 1986 have changed somewhat from those presented in late 1985. The external current account deficit for 1986 is now projected to amount to somewhat more than US$1,180 million (the equivalent of 7.1 percent of GDP), compared to US$1.300 million (8 percent of GDP) projected initially. The new projection is based on an average price for copper of US$0.664 a pound, some 1.5 cents below the level projected previously, reflecting recent developments and prospects in the copper markets. Non-copper and non-oil terms of trade are projected to weaken moderately. The current projection also assumes an average price for petroleum of US$16 a barrel for the period May-December 1986, which implies an average price for the year of US$17 a barrel. LIBOR and prime rates are expected to remain at levels of 7.0 and 8.5 percent, respectively. Net medium- and long-term capital inflows are expected to be lower than in the original projections; in particular, public sector capital inflows are not expected to exceed US$510 million, compared to some US$620 million projected initially, on account of lower than projected levels of financing from multilateral organizations. Short-term inflows, in turn, are expected to increase to US$335 million, as a result of higher private flows, which will more than offset the unwinding of trade financing related to oil imports. The overall balance of payments is therefore expected to record a surplus of US$50 million, compared with US$15 million expected initially. The external targets are compatible with a rate of growth of GDP in the order of 4.5 percent, reflecting increased private sector investment and higher exports. The additional investment effort would be financed with higher domestic savings, made possible by the impact of

lower petroleum prices. As had been projected previously, the rate of inflation is expected to decline from some 26 percent in 1985 to less than 18 percent in 1986.

16. If the current international situation persists, the continuation of the adjustment effort envisaged under the program beyond 1986 will result in further improvements in the external accounts, while consolidating the gains observed with respect to growth and inflation. The external current account deficit is expected to decline further in 1987 and the overall balance of payments should record a small surplus. The external outcome would be consistent with continued sustained growth in GDP and a reduction of inflation, but would require efforts in the area of fiscal and monetary policies in addition to those described in more detail below. In particular, the nonfinancial public sector deficit is expected to be reduced in 1987 in line with the original intentions under the program. However, in view of the budgetary process, the exact magnitude of the adjustment can only be determined later this year.

17. The achievement of the program's objectives for 1986 continues to hinge on the strengthening of the public sector finances. To this end, the nonfinancial public sector deficit, which was projected not to exceed 2.3 percent of GDP in 1986, has been revised to 2.2 percent of GDP. In line with this expected outcome, the net financing requirements of the nonfinancial public sector, which are equivalent to the sum of the overall deficit of the nonfinancial public sector and net capital revenues are projected at 3.1 percent of GDP in 1986. Public sector investment is projected to increase by 0.5 percentage points of GDP, as had been programmed, while public sector savings are projected to amount to the equivalent of 4.3 percent of GDP, in excess of the estimate made in late 1985.

18. While the policies being pursued this year are to a large extent those described in the letter of January 1986, in order to achieve the program objectives for 1986 the Chilean authorities have had to take significant additional measures to offset the reduced public sector profits on domestic petroleum production, resulting from the drop in international prices. During the period January-April 1986, domestic prices of gasoline and other petroleum products were reduced by some 16 percent, reflecting developments in international petroleum markets. The lower domestic prices would have had an adverse impact on the public sector finances by the equivalent of some 1.0 percent of GDP because of lower tax receipts and lower profits of ENAP on the sale of domestically produced oil, which accounts for about one half of total domestic consumption. To compensate for these losses the Chilean Government imposed a new tax that was applied as of May 1986 to most domestic consumption of gasoline and diesel oil. The tax is equivalent to a fixed amount per liter, plus a variable amount, equivalent to 70 percent of the difference between a reference price and ENAP's ex-refinery price before taxes. The fixed tax is the equivalent of US$0.08 a liter in the case of gasoline and US$0.04 a liter in the case of diesel oil. On the basis of the assumed price of petroleum of US$16 a

barrel for the remainder of the year, the new fuel tax will enable the public sector to offset most of the reduced profits associated with domestic production.

19. The Chilean authorities are firmly committed to keeping public sector expenditures within the budgeted levels as a mechanism for demand restraint. Accordingly, it is our firm intention not to allow increased expenditure on account of any petroleum tax revenue in excess of the amounts needed to compensate for other net revenue losses of the public sector resulting from lower petroleum prices. This policy will strengthen the savings and overall performance of the nonfinancial public sector.

20. Consistent with the revised fiscal program, limits have been established on the overall deficit of the nonfinancial public sector through December 31, 1986, as described in attached Table 1. As in the past, if the Chilean Development Corporation (CORFO), its affiliates, or other public enterprises sell stock of state owned enterprises beyond the amounts incorporated in the fiscal program, the public sector limits will be reduced by an equivalent amount unless the additional resources are relent to the private sector in excess of the base credit program. In addition, the limits would reflect the effect of the Copper Compensation Fund established within the context of the Structural Adjustment Loan Agreement with the IBRD.

21. Monetary policy will continue to support fiscal policy in pursuing the output, inflation and balance of payments objectives of the program. In particular, the Central Bank will limit its credit expansion to an amount that will allow for the achievement of the program targets. On that basis and the policies described in paragraphs 22 to 26 below, limits have been established on the net domestic assets of the Central Bank as shown in Table 2. In addition, targets have been established for the net international reserves of the Central Bank, as described in attached Table 3.

22. The Chilean Government remains committed to the elimination of the operating losses of the Central Bank. To a significant extent, this commitment is already being carried out by the ongoing elimination of subsidies on swaps. The interest rate subsidy on long-term foreign exchange deposits associated with restructured external loans is being reduced and will be eliminated by February 1987 through a schedule of monthly reductions. The interest rate subsidy on swap operations related to the proceeds of external loans contracted since February 1983 and other sources of foreign exchange is also being reduced. On May 8 the premium on those transactions was reduced from the previous 2.9 percent a year to 2.4 percent for swaps of up to 29 days. Swaps for other maturities were reduced also, with a maximum premium for maturities between 181 and 360 days having been set at 2.7 percent. The Government of Chile will further reduce the premium on a monthly basis for all maturities. Accordingly, the premium on new operations for maturities of up to 29 days shall be eliminated no later than February 28, 1987.

The premium on all other maturities will be reduced in line with the premium on maturities of up to 29 days and will be eliminated no later than April 30, 1987. While the Government of Chile intends to proceed with equal discrete monthly changes on a consistent basis, the need to avoid abrupt changes in short-term flows and reserves may at times require a somewhat different pattern of reductions. Also, the existing preferential dollar subsidy on the service of certain foreign currency-denominated debt is being phased out. The subsidy will be eliminated by the end of 1986, well ahead of the previously envisaged schedule. While the subsidy will continue to apply for some outstanding obligations with an original value of US$50,000 or less, these obligations are expected to be fully paid by the end of the program period. In light of the reductions in subsidies described above, the Central Bank's operating losses are expected to be eliminated in 1986 and are not expected to re-emerge in subsequent years. In any event, the progress being made in eliminating the operating losses of the Central Bank and in reducing the swap related subsidies, and any appropriate policy action, will be discussed with the staff at the time of the forthcoming review.

23. The Central Bank has reduced its discretionary role in allocating credit to the nonfinancial private sector, thereby alleviating the rigidities that have affected monetary policy. Domestic debt refinancing programs have been limited to the commitments existing at the beginning of 1985, and selective credit operations have been restrained. The Government will continue these policies, which have permitted the Central Bank to increase its reliance on nonselective operations to rechannel financial resources within the economy. Moreover, the Government intends to absorb the losses of the Central Bank through periodic recapitalizations of the institution.

24. Interest rates are mainly determined by market forces. The Central Bank continues to provide an indication of maximum nominal interest rates on 30-day deposits to financial institutions, based on the expected rate of inflation plus a premium, so as to help provide for a positive real interest rate. However, the Government is committed to eliminate the indicative rate as the financial system renews its strength. In recent months, nominal interest rates have declined in line with inflation. However, the competitiveness of domestic financial savings instruments has been maintained, notwithstanding the reduction in the subsidies granted to foreign capital inflows in the form of interest rate premiums on swap operations, and private short-term capital has continued to flow into the country. The Chilean authorities will monitor closely the levels of such inflows in order to sterilize their effects on the financial system when appropriate, and to protect the objective of eliminating the operating losses of the Central Bank. In this respect, the monetary authorities have reduced the spread over LIBOR paid on dollar-denominated Central Bank notes by more than 1 percentage point. Meanwhile, interest rates on the credit operations of the Central Bank have been adjusted to reflect the cost of funds to the institution.

25. The re-establishment of a solvent private financial system has remained a major aim of economic policy. The solvency and liquidity of the private banking system is being improved through the purchase by the Central Bank of part of their sub-standard portfolio; these purchases are expected to be completed by end 1986. In addition, legislation was enacted that enables the Government to recapitalize the intervened banks directly but limits the participation of the state in the capital of these banks to a period of five years, and provides for a government transfer to the Central Bank to cover the potential losses arising from these operations. This legislation has enabled two of the five intervened banks to be recapitalized and returned to private sector management. The Government expects that the capital of the remaining intervened banks will be reconstituted in the near future. Further, the existing banking law is being modified to improve the supervision of the operations of the private financial system.

26. The Government has followed a wage policy intended to strengthen external competitiveness, raise the level of employment, and maintain inflation low. A public sector wage increase, which averaged about 15 percent, was implemented in December 1985, and no further increase is intended before December 1986. Moreover, the Government will continue to abstain from interfering with wage negotiations in the private sector, and will seek to preserve flexibility in the labor market. Except for the minimum wage, settlements in the private sector are determined either by collective bargaining or individual agreement.

27. In order to sustain the emerging strength of the balance of payments during the forthcoming months, the peso will continue to 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 0.35 percent per month. This estimate will be reviewed continually and the exchange rate will be modified as appropriate to ensure Chile's competitiveness. Further, the Government will continue to monitor closely developments in the balance of payments, including changes in the terms of trade, exchange rate movements for major currencies, the availability of financing, and developments in the foreign exchange market. In this context, any required corrections will be made in order to create the conditions for sustained economic growth. To support further the competitiveness of the external sector, the Government will not increase the uniform tariff rate during the remainder of the program.

28. The Government has substantially completed its efforts to assist the private sector in restructuring its external debt. The Government will not guarantee any private external debt other than those restructured obligations of the financial private sector included in the recently concluded agreement with foreign commercial banks. Moreover, foreign creditors are required to pay a commission to the Central Government for the guarantee of those obligations arising from the 1985-87 restructuring.

29. In recent weeks, the Central Bank has introduced some modifications to the mechanism created in late 1985 that permits private residents and nonresidents to purchase selected external claims on Chilean debtors at a discount, provided that the foreign exchange is not obtained in the official foreign exchange market. Through the existing mechanism, Chile can benefit from the discount currently prevailing in secondary markets for such instruments abroad, thereby reducing its external debt service payments and alleviating pressures on reserves. The original regulations were very successful and a total of US$274 million of external debt instruments were brought back between the inception of the program and March 31, 1986. Prior to the recent modifications, the scope of these operations was limited; in the case of domestic residents, these assets or the proceeds from their sale could only be used to reduce domestic debt or to purchase specified domestic assets. The new modifications widen both the scope of external debt that could be purchased and the domestic use of the assets or the proceeds from their sale.

30. The Government of Chile has now completed the restructuring of principal payments falling due to commercial banks during 1985-87, and has secured additional financing for 1985-86. In addition, Chile has signed all bilateral agreements with official creditors related to the restructuring of certain principal payments falling due in the period July 1985-December 1986. The Government of Chile is currently assessing the financial needs that Chile will confront over the period 1987-88, within the context of the ongoing effort to reduce net foreign borrowing, and every effort will be made to return to more normal access to foreign financing from commercial banks. Specifically, the effect of the dismantling of the 120-day deferment period for import payments will be taken into account within the context of the external financing requirements for the 1987 economic program. In the Memorandum of Economic Policies of January 20, 1986 the Chilean authorities established limits on the outstanding stock of short-term debt owed by the nonfinancial public sector and the Banco del Estado, described in attached Table 4. Also, ceilings were placed on the contracting and guaranteeing of external debt by the public sector on maturities of more than one year and up to ten years with a subceiling on maturities of up to five years, as described in Table 5 of that memorandum. These limits remain unchanged. Finally, limits were established on the rescheduling operations of the public sector and on those guaranteed by the public sector, also described in Table 5 of that memorandum. These limits also remain unchanged.

31. Chile's exchange system temporarily includes certain multiple currency practices and restrictions on payments and transfers for current international transactions. The Government of Chile continues to be committed to the elimination of these restrictions and practices before the end of the period of the arrangement and is proceeding in this regard as programmed.

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

(In billions of pesos)

	Cumulative Limit
January 1-March 31, 1986	14.2
April 1-June 30, 1986	44.3 2/
July 1-September 30, 1986	59.3 3/
October 1-December 31, 1986	71.8 3/
January 1-March 31, 1987	... 4/
April 1-June 30, 1987	... 4/

1/ Adjusted downward for any cumulative increase in deposits in the copper income stabilization fund (Fondo de Compensación del Cobre), and upward for any cumulative decrease in deposits in the copper stabilization fund.

2/ The above limits shall be adjusted downward for any revenue in excess of Ch$10 billion derived from the sale of stock by CORFO, its affiliates or other public enterprises, unless compensated by new credits to the private sector.

3/ The above limits shall be adjusted downward for any revenue in excess of Ch$19.3 billion derived from the sale of stock by CORFO, its affiliates or other public enterprises, unless compensated by new credits to the private sector.

4/ These limits shall be established no later than January 31, 1987.

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

(In billions of pesos)

Period	Ceilings
Stock outstanding December 31, 1985 (actual)	546.0
January 1-March 31, 1986 (actual)	595.8
April 1-June 30, 1986	636.0
July 1-September 30, 1986	694.0
October 1-December 31, 1986	730.0
January 1-March 31, 1987	... 3/
April 1-June 30, 1987	... 3/

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. These ceilings will be adjusted downward for any cumulative increase in deposits in the copper income stabilization fund (Fondo de Compensación del Cobre), and upward for any cumulative decrease in deposits in the copper stabilization fund.

2/ For purposes of the ceilings, the medium- and long-term liabilities of the Central Bank will include disbursements under any SAL and cofinancing loans obtained from the IBRD and commerical banks by the nonfinancial public sector. Further, all transactions involving the direct external debt of the Central Bank under Chapters XVIII and XIX of the foreign exchange compendium will continue to be treated as medium- and long-term foreign liabilities of the Central Bank.

3/ These ceilings shall be established no later than January 31, 1987.

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

(In millions of U.S. dollars)

Date	Targets
December 31, 1985 (actual base)	1,080.2
March 31, 1986 (actual)	985.6
June 30, 1986	1,060.0
September 30, 1986	943.0
December 31, 1986	1,130.0
March 31, 1987	... 2/
June 30, 1987	.. 2/

1/ Adjusted upward for any cumulative increase in deposits in the copper income stabilization fund (Fondo de Compensación del Cobre) and downward for any cumulative decrease in deposits in the copper income stabilization fund.

2/ These targets shall be established no later than January 31, 1987.

Table 4. Chile: Limits 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	Limits
December 31, 1985 (actual stock)	878
January 1-June 29, 1986	960
June 30, 1986 (stock)	940
July 1-December 30, 1986	1,010
December 31, 1986 (stock)	990
January 1-June 29, 1987	... 2/
June 30, 1987 (stock)	... 2/

1/ Net of gross short-term foreign assets of the Banco del Estado, excluding gold.
2/ These limits shall be established no later than January 31, 1987.