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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/39

10:00 a.m., February 28, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	D. C. Templeman, Temporary
	G. Ercel, Temporary
	T. Alhaimus
H. Fujino	
	B. Goos
Huang F.	
	S. Ganjarerndee, Temporary
A. Kafka	J. R. N. Almeida, Temporary
T. P. Lankester	M. Foot
	S. Simonsen, Temporary
	L. Leonard
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
	G. Ortiz
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
	H. Alaoui-Abdallaoui, Temporary
	A. Vasudevan, Temporary
	N. Coumbis

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

IBRD: P. Eigen, Latin America and the Caribbean Regional Office. Central Banking Department: L. M. Koenig, Deputy Director. European Department: B. Rose, Deputy Director. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; C. Brachet, A. Chopra, A. B. Petersen. External Relations Department: H. P. Puentes. Legal Department: J. V. Surr. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; A. Lanyi. Secretary's Department: A. P. Bhagwat. Treasurer's Department: D. Berthet, J. E. Blalock, J. C. Corr, D. Gupta. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, J. Ferrán, J. Jaramillo-Vallejo, P. Kohnert, J. E. Leimone, C. M. Loser, C. G. Muniz B., L. L. Pérez, R. K. Rennhack. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, W.-R. Bengs, L. P. Ebrill, G. Nguyen, P. Péterfalvy, Song G. Assistants to Executive Directors: M. Arif, A. Bertuch-Samuels, B. Bogdanovic, F. Di Mauro, R. Fox, S. Geadah, G. D. Hodgson, L. Hubloue, Z. b. Ismail, J. M. Jones, S. King, H. Kobayashi, R. Msadek, A. H. Mustafa, J. Reddy, J. E. Rodríguez, C. A. Salinas, L. Tornetta, A. J. Tregilgas, Wang X., Yang W.

1. BRAZIL - FINANCIAL MEASURES

Mr. Kafka said that his Brazilian authorities had informed him the previous evening that they had undertaken a major monetary reform and de-indexation of the economy. As soon as he received the details by telex, he would make them available to the staff (see EBD/86/57, 3/3/86).

Brazil's program had similarities with that undertaken by Argentina, but there were significant differences, Mr. Kafka noted. A major difference was that although a new Brazilian currency had been introduced--called the cruzado and worth 1,000 present cruzeiros--the exchange rate had not been frozen but merely fixed so that, if necessary, it could be adjusted. Prices were frozen for 90 days. Wages would no longer be indexed every six months. They would reflect the average real wage of the previous six months. Sight obligations were being converted at par from cruzeiros; for nonindexed obligations, a conversion factor calculated to reflect the imputed inflation rate would be used, as in Argentina. Obligations would not be indexed for at least one year--except for savings deposits, which would be indexed on a three-month basis.

The Chairman said that he wished Brazil every success in implementing its plan, which could be a watershed in its approach toward inflation.

2. CHILE - REVIEW UNDER EXTENDED ARRANGEMENT, AND MODIFICATION AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered a staff report for the review under the extended arrangement, which had become effective on August 15, 1985, together with a proposed decision on a modification of the arrangement and waiver of a performance criterion (EBS/86/20, 1/30/86).

The staff representative from the Western Hemisphere Department made the following statement:

> The Chilean economic situation remains substantially as presented in the staff report for the review under the extended arrangement and request for modification and waiver (EBS/86/20, 1/30/86). Since the issuance of the report the staff has received the following supplementary material.
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> Information for end-December 1985 shows that all of the quantitative performance criteria were observed. Net international reserves of the Central Bank exceeded the program target by a margin of about US$5 million, and the net domestic assets of the Central Bank were below the limit by a margin of about Ch$15 billion. The outstanding indebtedness of the nonfinancial public sector was below the program limit by about Ch$13 billion, implying an overall deficit equivalent to 2.6 percent of GDP, compared with 3.1 percent contemplated in the program. The

ceilings on the contracting of medium- and long-term external debt and on the short-term external indebtedness of the nonfinancial public sector and the Banco del Estado were also observed with ample margins.

Inflation during the month of January 1986, as measured by the Consumer Price Index (CPI), was 2.7 percent, a rate somewhat higher than had been expected. The January inflation resulted in part from domestic petroleum price increases averaging 6 percent in late December 1985. Inflation is expected to decelerate substantially during February as a rollback of 7 percent in domestic petroleum prices was effected at the beginning of the month in response to the decline in the world market price of petroleum.

Progress has been made in concluding the bilateral agreements for restructuring debt owed to foreign official creditors. As of February 6, 1986 bilateral agreements had been signed with France, Spain, the United Kingdom, and the United States for a total amount of US$125 million. It is expected that bilateral agreements will be signed with Austria, Germany, and Japan by the end of March for an additional amount of US$25 million.

Mr. Nebbia made the following statement:

As on previous occasions, the staff has provided us with a complete assessment of the Chilean economy and with a fair evaluation of progress made already in the context of the Fund-supported economic program. My authorities agree with most of the views and suggestions set forth in the staff report. In particular in the appraisal, and they wish to thank the staff and the management for the cooperation and continuous advice that has been provided in order to help the Chilean economy recover from its difficulties.

As mentioned by the staff, in July 1985 the Chilean authorities and the Fund agreed on a medium-term program of economic adjustment in the form of a three-year extended arrangement in an amount equivalent to SDR 750 million. The main obectives of the medium-term economic program--as noted at the time Fund support was requested--remain those of reducing the external current account deficit while achieving sound economic growth and slowing inflation. It also aims at consolidating and further improving the gains achieved in the re-establishment of financial stability.

During 1985 the objectives of the program were achieved to a significant degree, and the overall performance under the program has been encouraging. In particular, all performance criteria through November were observed except for the net international reserve target and the commitment to increase travel allowances for tourism. As noted by the staff, the said noncompliance reflected exclusively the delays experienced in the completion of the financial package with foreign commercial banks. Consequently, the first disbursement of the new money in mid-December enabled Chile to meet the international reserve target, and the Central Bank was then in a position to approve the increased allocation for travel. In this respect, completion of the financial package with foreign commercial banks, offical creditors, and multilateral agencies, has provided not only adequate balance of payments financing over the program period but it has also been particularly important for the improvement in the structure and terms of the country's external debt.

The progress already made during 1985 was achieved in spite of two major adverse circumstances: Chile's terms of trade deteriorated even further, reflecting lower prices for noncopper exports; and the earthquake that struck the country in March 1985 caused considerable economic losses, now estimated to amount to the equivalent of US$1.0 billion, or some 6 percent of GDP.

Consequently, for the whole year, real GDP growth has been tentatively estimated at about 2 percent, a figure which is somewhat below the original estimate. Notwithstanding this weaker than expected performance, the unemployment rate was reduced to 11.9 percent during the last quarter of the year, compared with the rate of 14 percent observed by the end of 1984.

Price performance in 1985 has been encouraging, with the rate of inflation for the year being close to the target of 25 percent, against 35 percent in the 12-month period ended in June 1985. Such improvement reflected, to a large extent, the pursuit of sound demand management and wage policies. The most decisive action was the sharp reduction in the overall deficit of the nonfinancial public sector, from an annual rate of almost 7 percent of GDP in the second half of 1984 to about 3 percent of GDP for the whole year 1985. The decline occurred notwithstanding a lower than projected level of revenues, to which the Chilean authorities responded by keeping expenditures well below program levels, in spite of the reconstruction effort. In addition, public sector savings increased substantially, from 0.6 percent of GDP in 1984 to 3.4 percent in 1985, allowing for some improvement in the levels of investment in priority areas.

In support of the above-mentioned fiscal adjustment, monetary policy continued to be managed prudently and within the limits agreed in the program. Financial savings increased in real terms, reflecting an increased strengthening of private pension plans and higher deposits by the public in general. To a large extent, the latter reflects growing confidence with respect to the outcome of the stabilization program, as well as the appropriate degree of competitiveness of domestic financial savings instruments. In this regard, it should be noted that interest rates continued to be determined mainly by market forces, and remained positive in real terms throughout 1985.

In the external area, the current account deficit was broadly in line with program projections, amounting to some $1.3 billion, or 8.3 percent of GDP. However, its structure differed somewhat from the one originally envisaged in the program. In fact, the trade surplus was lower than expected--$0.7 billion instead of US$1.1 billion--reflecting a deterioration in the prices of noncopper exports that was only partially offset by an increase in the volume of such exports. The lower than expected trade surplus was nevertheless compensated by lower interest rates in the international capital markets, the receipt of insurance payments related to the earthquake damage, and the reprogramming of interest payments granted by commercial banks.

The exchange rate policy also continued to be managed flexibly and in line with the purpose of increasing competitiveness, both with respect to export promotion as well as efficient import substitution. In real terms, the Chilean peso was depreciated by 12 percent in 1984 and 17 percent during the first half of 1985, while it continued to be adjusted on a daily basis so as to reflect inflationary differentials between Chile and its main trading partners.

In support of the exchange rate policy described above, tariffs were reduced from 35 percent to a uniform level of 20 percent, well ahead of the original schedule.

In spite of the weaker than expected performance of output during 1985, and the further deterioration of the country's terms of trade in the same period, the Chilean authorities remain fully committed to continuing the structural adjustment process in order to increase domestic savings and exports, as well as persevering with the policies pursued to date aimed at improving the current account of the balance of payments, strengthening the private sector, reducing inflation, and reassuming self-sustained economic growth.

For 1986, and on the basis of the assumptions adopted in the world economic outlook exercise, the Chilean authorities have projected an unchanged current account deficit of US$1.3 billion, or the equivalent of 7.8 percent of GDP. Such an outcome is consistent with a rate of growth of GDP in the order of 4.0 percent, and given the levels of foreign financing on which agreement has been reached, will allow for a modest surplus of the overall balance of payments amounting to some US$15 million.

In addition, the projected current account deficit for 1986 is consistent with an appropriate level of domestic savings, a further reduction in the rate of inflation--not to exceed 18 percent in the year--and with an additional reduction of the deficit of the nonfinancial public sector.

In this respect, the nonfinancial public sector deficit remains the cornerstone in the whole adjustment effort. Consequently, the authorities intend to further reduce it to 2.3 percent of GDP in 1986. In turn, such development will mean a substantial decline in the financial requirements of the sector, amounting to some 0.6 percentage points of GDP in the 1986 exercise. In addition, public sector savings are projected to increase further during 1986, amounting to an equivalent of 4.2 percent of GDP, meaning an improvement of 0.8 and 3.6 percentage points of GDP compared with the performance in 1985 and 1984, respectively.

Since general government current revenues are projected to decline, reflecting the reduction of import tariffs and the implementation of the third year of a tax reform designed to stimulate private savings and investment, and since investment outlays are programmed to rise, mainly because of reconstruction needs, the total fiscal adjustment will depend basically on continued restraint over current expenditures. Accordingly, it is now projected that current spending will decline from 29.8 percent of GDP in 1985 to 27 percent in 1986.

Monetary policy will continue to be managed cautiously and in line with the objectives or output, inflation, and the balance of payments stated in the program. Credit expansion will remain consistent with the achievement of a more balanced fiscal position and within the limits allowed by the program. Moreover, the authorities are firmly determined to eliminate the Central Bank's operational losses, and a schedule has been established for the elimination of the remaining subsidies on swap and related dollar operations of the Central Bank.

As for interest rate policy, the authorities' view remains that of enhancing the role of market forces in its determination. To that end, they have committed themselves to eliminating the current indicative rate provided by the Central Bank as soon as the strength of the financial system is renewed. In the meantime, the indicative rate is intended to be set as a positive and competitive real rate so as to foster savings and an efficient allocation of investments.

On wage policy, the authorities will continue to follow a quite similar approach to the one of the preceding years--namely, a policy aimed at strengthening external competitiveness, raising the level of employment, and helping to keep inflation low. A public sector wage increase averaging about 15 percent was granted in December 1985, approximately in line with the expected inflation for 1986.

Insofar as export performance remains the core of the medium-term strategy, the Chilean authorities will continue to pursue a flexible exchange rate policy capable of reflecting the comparative advantages of the country by ensuring an appropriate degree of competitiveness for both export and import-substitution industries. With that aim, the peso will continue to be devalued on a daily basis in line with inflationary developments inside and outside the economy. In addition, the authorities will monitor closely developments in the balance of payments, including changes in the terms of trade, the foreign exchange markets, the degree of access to external financing, as well as in interest rate movements.

The Chilean authorities have repeatedly expressed their conviction that they will have to work closely with the Fund for many years to come. Their full adherence to the programs on which they have embarked, even when faced with external as well a domestic disturbances, reflect their will and capability to implement the needed corrective measures as soon as they proved to be required. The pursuit of orderly and sound domestic policies within the limits of what is possible remains the key characteristic of their adjustment record, and they look forward to maintaining their open and straightforward relationship with the Fund as a valuable means for improving the formulation of economic policy in the country and for achieving a better understanding of its current difficulties.

Mr. Almeida said that he was happy to note that the program aimed at a moderate increase in real GDP and consumption, the latter having fallen in the past five years. It was a strong and very detailed program, with 11 performance criteria of which 6 were quantitative. Too many performance criteria inhibited flexibility in economic policies, and increased the probability that the country would have to request waivers and modifications, as Chile had already done twice since the arrangement became effective in August 1985. It was certainly better to have a small number of performance criteria than too many.

In that connection, Mr. Almeida recalled the discussion by the Executive Board of Chile's request for the extended arrangement, when it had also considered the staff report for the 1985 Article IV consultation (EBM/85/106, 7/15/85). Several Executive Directors had expressed concern about the nature of the quasi-fiscal deficit of the Central Bank, suggesting that it should be integrated with the fiscal accounts. He remained unconvinced, even after reading the minutes of that discussion, by the staff's explanation that it was difficult to distinguish between the capital and operating losses of the Central Bank; in point of fact, the distinction had been drawn in the staff report under discussion. The difference could be very important because the operational losses of the Central Bank on a cash basis had increased from a minimum of 2.8 percent of GDP in 1984 to 4.3 percent of GDP in 1985, as mentioned in the footnote on page 10 of EBS/86/20. Perhaps the staff should follow the example of the stand-by arrangement for Uruguay in which the total deficit of the Central Bank had been considered as a program target, or the stand-by arrangement for Argentina, in which the combined deficit of the nonfinancial public sector and the Central Bank was a performance criterion.

There were a number of changes in the staff report that he greatly appreciated, Mr. Almeida commented. First, the detailed appendix on World Bank operations had not been included in previous staff reports. Second, the sensitivity analysis in the medium-term scenarios was very precise and helped to understand the risks associated with the program. Third, those scenarios had not been designed mechanically but had assumed a current account that would represent a move toward a sustainable balance of payments consistent with the policies being pursued over the period. Fourth, the technique of devising indicative quantitative performance criteria for the last six months of the year reduced the uncertainties of medium-term economic policies.

Finally, Mr. Almeida said that he agreed with the staff that there was little margin for adverse developments in the Chilean economy, and that the authorities would need to be attentive to attain the external objectives of the program. He supported the proposed decisions.

Mr. Suraisry said that he was in general agreement with the staff analysis and that he supported the proposed decision. The Chilean economy had been undergoing significant economic adjustment since mid-1982. Following some setbacks in 1984, that adjustment effort had been intensified; in particular, as of August 1985, Chile had entered into a three-year extended arrangement with the Fund. All the evidence indicated that the authorities had made commendable progress toward achieving the goals of that program, and he could therefore confine his comments to brief remarks on demand management and supply-side policies.

On the demand side, the authorities had taken commendable steps to reduce the fiscal deficit, Mr. Suraisry noted. The pursuit of a restrained wage policy and the reduction in the financing requirement of the nonfinancial public sector were noteworthy. As the authorities were aware, a continued improvement in public sector finances was important for reducing the large imbalances in the economy. In that context, Mr. Nebbia's statement was reassuring.

It was encouraging that fiscal policy was being usefully complemented by an appropriately cautious monetary policy, Mr. Suraisry added. In addition, the authorities had adopted a number of measures to improve the working of the financial system. He commended them on the measures designed to improve the financial situation of the Central Bank, as evidenced by the elimination of its losses, and to strengthen the commercial banks. There had also been a desirable shift from monetary control based on discretionary action to monetary control based on the restraint of credit expansion by the Central Bank, which was essential for the conduct of an effective monetary policy.

The staff had cautioned that over the medium term the balance of payments was extremely vulnerable to adverse external events, particularly as external debt would remain high by any standard for a long time, Mr. Suraisry observed. Continued pursuit of firm domestic policies and cautious external debt management would therefore be required. In that context, he endorsed the authorities' efforts to reduce, over time, the ratio of debt to GDP, to rely less on foreign bank credit, and to refrain from guaranteeing private sector external debt.

On the supply side, Chile had achieved a great deal but much remained to be done, Mr. Suraisry stated. Historically, Chile's rate of savings had been very low, both absolutely and in comparison with that of other countries. In 1985, for example, national savings were estimated to have been only 5.7 percent of GDP. Thus, it was not surprising that the fiscal deficit for the year seemed to have been financed totally from foreign sources. Measures to stimulate domestic savings were clearly of paramount importance, especially as the room for relying on foreign sources was very limited. Obviously, those measures needed to strike a balance between the overall public sector borrowing requirement (PSBR) and the need to stimulate private sector savings and investment. He had been glad to note that the program paid special attention to that objective. In particular, the tax reform was directed at reducing the tax burden on savings. The progress being made in reducing corporate taxes was a good first step. In view of the faster than anticipated reduction in tariffs, it might be necessary to postpone the reform of other direct taxes in order to ensure an adequate level of public revenue. However, tax reductions were essential for stimulating growth, which would greatly facilitate the smooth management of Chile's external debt and also increase domestic savings.

Supply-side measures to enhance the efficiency of the external sector were also important, Mr. Suraisry considered. The large tariff reductions put into effect recently were courageous and commendable and, fortunately, had continued to be supplemented by a flexible exchange rate policy. Preserving the competitiveness of exports would be instrumental to the success of Chile's efforts to bring its economy back on track. The elimination of other market distortions was equally important.

For the program to be successful and for the adjustment momentum to continue, the Fund and the World Bank needed to work very closely together, Mr. Suraisry concluded. The World Bank's previous involvement in Chile was welcome since, inter alia, it had made the implementation of the mainly structural measures emphasized in the extended arrangement much easier.

Mr. Ortiz observed that the staff report contained a very clear presentation of both economic developments and policy intentions. The macroeconomic data provided made it possible to construct a complete picture of the Chilean economy and to follow the major trends. Of particular use was the presentation in Tables 3 and 7, which contained the main economic indicators for the period 1982-86 and the most important macroeconomic flows for the period 1983-86. Interest rate developments, in both nominal and real terms--to which however only brief reference had been made in a footnote--might have been covered in greater detail. It would also have been useful to have a breakdown of the financial sector liabilities into those denominated in domestic and foreign currency.

Taking up a general issue, Mr. Ortiz observed that as Mr. Nebbia had pointed out in his statement, Chile had complied with all performance criteria but the results obtained from the program, although generally satisfactory, had fallen short of expectations in the areas of economic growth and the trade balance owing to the effects of the devastating earthquake suffered earlier in 1985 and to the worsening of the external environment for Chile. After a substantial deterioration of the terms of trade in 1984 of the order of 8.5 percent, a further deterioration had been experienced in 1985, of the order of 4 percent. Thus, in spite of an increase in export volume of a little over 6 percent, preliminary estimates of total export value indicated virtually no change, real consumption had declined, and real wages had suffered a further, albeit modest, erosion. Perhaps more important, in spite of the stringent adjustment that Chile had been undertaking in the past few years, its ability to service external debt had worsened. Thus, it could be seen from Table 8 that the ratio of external debt to exports had risen from 409 percent in 1984 to 433 percent in 1985, and the expected decline in that ratio for 1986 would not be sufficient to return it to what it had been in 1984. Furthermore, debt/GDP ratios were expected to rise slightly until 1987 after which they would begin a gradual decline.

It was illustrative to compare the medium-term projections in the staff report under discussion with those presented by the staff less than a year previously in EBS/85/122 (5/13/85) on Chile's request for the extended arrangement, Mr. Ortiz noted. In the earlier staff report, the projections were for the debt/GDP ratio to peak at 105 percent in 1986 and then to decline to about 72 percent in 1990; in the current report (EBS/86/20), the debt-GDP ratio was projected to decline from 124 percent in 1987 to 104 percent in 1990. The staff had noted that the drastic modifications of the medium-term scenario projections reflected in part a larger than expected real depreciation of the Chilean peso against the U.S. dollar, and thus a lower GDP measured in U.S. dollars. But that development was not merely statistical, since presumably the depreciation had taken place in the face of the worsening external environment, which the staff had noted correctly had been manifested primarily in the deterioration of the terms of trade. Thus, the higher debt/GDP ratios did reflect a diminished ability of the economy to service its debt.

Predictably, the staff had concluded that the worsening external conditions would require a more restrictive policy stance than had been envisaged when the program was designed, Mr. Ortiz continued, suggesting that tighter financial policies and further changes in relative prices might be needed to sustain the modest economic growth rates--in the order of 3 percent--contemplated in the program. In that connection, and without questioning the possible need for further adjustment, it was clear that more restrictive financial policies would result in even higher domestic interest rates, while a more active exchange rate policy--what the staff presumably meant by changes in relative prices--would surely entail initial contractionary effects. The net result would probably be an economic recession instead of the preservation of growth targets. While it was true that savings rates in Chile had traditionally been low, it might be noted that the large gap between national savings and domestic savings shown in Table 7 of EBS/86/20 corresponded to interest payments made abroad. In fact, Table 8 indicated that interest payments on external debt would remain substantially above 11 percent of GDP until 1989.

Examination of the figures he had mentioned suggested that it would be extremely difficult for Chile to sustain even modest rates of economic growth unless the interest burden was reduced substantially in years to come or unless the relatively high current account deficit continued to be financed externally, Mr. Ortiz stated. Apart from the fact that interest payments on external debt would remain above 11 percent of GDP until the end of the decade, the medium-term projections in Table 8 showed that the current account deficit would decline from 8 percent of GDP in 1985 to 1.5 percent in 1990. The implication of course was that the net transfer of resources abroad, or the difference between foreign savings--equivalent to the current account deficit--and interest payments on external debt would increase from about 3.4 percent of GDP in 1985 and 1986 to 9 percent of GDP in 1990. The question that immediately arose was whether that trajectory seemed compatible with economic growth.

Sustaining even modest growth under such a scenario implied that national savings would have to increase by the amount necessary to close the gap left by the transfer of resources abroad, Mr. Ortiz noted. Although that increase in savings might be possible--the overall savings rate had risen remarkably since 1983--it would be at the cost of depressed consumption and only if there were large gains in productivity. As the staff had pointed out, the medium-term outlook remained uncertain, and the economy was vulnerable to external developments. Thus, the World Bank-supported strategy of widening and diversifying the export base seemed to be the only means of reducing that vulnerability.

Referring more briefly to specific aspects of the program, Mr. Ortiz considered that the general thrust of fiscal, monetary, and exchange rate policies seemed appropriate. He agreed with the staff and Mr. Nebbia that a key aspect of the adjustment process was the generation of substantially improved public sector finances. Monetary developments in

1985 had been quite encouraging. The rapid rise in the real value of liabilities held by the financial sector, coupled with the declining inflation trend, supported the view that the expansion of monetary aggregates and financial savings had probably been induced by heightened confidence on the part of the private sector. The staff had noted that the private sector's increased holdings of financial assets had taken the form of savings and foreign currency deposits. Although a precise breakdown of the composition of those deposits had not been provided, the creation of foreign currency denominated deposits in the banking system was well known as being potentially troublesome, and called for the exercise of caution.

The authorities were committed to the elimination of the operational losses of the Central Bank arising from the preferential exchange rate applied to the repayment of exchange rate notes and to interest subsidies on swap operations in foreign currency, Mr. Ortiz noted. Given the magnitude of those losses in 1985, amounting to over 4 percent of GDP, he had been surprised to find no comment by the staff on the potential impact of their elimination in 1986. Surely, the reduction of interest subsidies and the elimination of the preferential exchange rate applied to certain operations would have an important impact on the private sector affecting, at least in the short term, the profitability of the firms involved in those operations. Again, given the magnitude of the figures, it was puzzling that the staff contemplated an increase in 1986 of both public sector savings and private sector savings, together with the elimination of exchange losses.

Finally, Mr. Ortiz said that he welcomed the Government's intention not to extend any further guarantees to private external debt. The guarantees extended thus far implied a heavy burden on the state. The insistence on the part of creditor banks on the extension of such guarantees was short sighted and contradicted the calls that had been made by the private sector for a larger role in the economy. He had been greatly interested in the scheme created by the Central Bank to permit private residents and foreign investors to purchase public and private debt at a discount on the secondary market. That capitalization scheme appeared to hold out promise for the badly needed reduction of Chile's debt burden.

Mr. Templeman recalled that when the Executive Board had approved an extended arrangement for Chile, it had been obvious that a difficult adjustment effort lay ahead if Chile was to restore economic growth, expand exports, and achieve a sustainable external position in the face of an extremely heavy debt burden and high dependence on the uncertain world copper market. It seemed fair to say that the adjustment effort had been going forward rather well, with the help of substantial external financial support from the Fund, the World Bank, commercial banks, and official creditors. Formal performance criteria had generally been met and actual economic performance had been quite good. In 1985, targets had been reached or exceeded with respect to domestic savings, gross fixed investment, and growth in the volume of exports. Those were all key variables for the correction of the large savings/investment and current account imbalances of past years. Furthermore, the rate of inflation, the current account deficit, and the public sector deficit were all roughly on track. Only the growth of real GDP had fallen short of expectations, at 1.5 percent to 2 percent compared with the 3 percent target.

The structural content of the program was a particularly important feature if the savings/investment performance was to be improved in order to expand and diversify the economy and still permit Chile to meet its foreign debt obligations, Mr. Templeman stated. In fact, the Chilean economy was already rather free of the restrictions and disincentives that had plagued a number of member countries by limiting the freedom of relative prices to send the proper signals throughout the economy. In addition, a number of structural reforms were under way. Thus, the price of capital in the form of interest rates was determined mainly by market forces and those rates were positive in real terms. The price of labor was also determined through collective bargaining in the private sector and, for public employees, by restrained government action. The price of foreign exchange was kept flexible through a daily crawl tied to relative domestic and foreign price movements. And the substantial current surpluses of public enterprises suggested that the prices of the goods and services that they produced had been kept at realistic levels.

Furthermore, a number of structural reforms were being introduced in the areas of taxation, financial markets, public enterprise, and trade and payments, Mr. Templeman noted. Corporate tax rates were being reduced, and an interesting experiment to stabilize fiscal income from copper earnings was under way through the Copper Compensation Fund. Reform of the banking system seemed to be mainly corrective in nature, and related to the intervened banks, which were to be recapitalized and returned to private management. The expected modification of bank supervisory legislation should help to avoid similar problems in the future. In the public enterprise sector, the sale of shares in the Chilean Development Corporation and in other public enterprises offered an investment vehicle for private investors while permitting the proceeds to be used for deficit reduction, lending to the private sector, or other purposes. And in the trade policy field, good progress was being made in reducing the uniform customs tariff level ahead of schedule and in gradually eliminating multiple currency practices and exchange restrictions by the end of the period of the extended arrangement.

On earlier occasions, his chair had highlighted the need for Chile to strengthen its savings/investment performance, Mr. Templeman recalled. In fact, there had been some important developments in recent years. In 1981, the ratio of gross domestic investment to GDP had approached 23 percent, nearly two thirds of which however had been financed with foreign savings, reflecting the contemporaneous build up of a very high level of foreign debt. Gross national savings in that year had exceeded 8 percent of GDP but had fallen to a low point of less than 2 percent of GDP in 1983. In 1985, there had been some recovery in the investment ratio to 14 percent of GDP, higher than in the preceding three years and above the program targets. The gross national savings rate had also risen to the highest level since 1981 but was still less than 6 percent of GDP. Unfortunately, the strengthening of the savings effort had been confined to the public sector, as the private savings rate of 2.4 percent of GDP in 1985 was about the same as in 1984 and lower than that in the previous three years. Clearly, there was need for improvement in that respect. It had to be recognized that the domestic savings rate had shown a considerable increase, rising from a low point of less than 10 percent of GDP in 1983 to about 17 percent in 1985. However, as Mr. Ortiz had noted, the need to direct a large part of those savings to cover interest on the foreign debt had reduced the savings available for domestic investment. It seemed to him that the appropriate approach would consist of a stronger effort at mobilizing private savings and a very cautious attitude toward the assumption of more foreign debt.

In the public sector, both the tax burden and the size of current expenditures of the public sector relative to GDP had generally declined, with a corresponding rise in the proportion of public expenditures devoted to investment, Mr. Templeman observed. That pattern should help to accelerate the growth of the economy and to create a more favorable environment for private investment. Also, the public sector deficit had been falling somewhat. However, while avoidance of domestic financing of the deficit as a contribution to monetary stability made some sense, the continued resort to foreign borrowing, even on better terms, was rather risky. In contrast to many other cases examined by the Board, Chile's public enterprises seemed to have put in a generally favorable performance, with substantial current surpluses, major contributions to the government tax revenue, and increasing investment outlays. The positive evaluation of Chile's public investment strategy by the World Bank, and the authorities' request for technical assistance from the Bank in public sector management, attested to the generally prudent fiscal policies being pursued. However, he wondered why the anticipated reduction in the tax rate on wages and salaries had been postponed and when the cut might eventually take place because of its importance in encouraging private savings.

He had already alluded to efforts under way to strengthen the banking system, Mr. Templeman recalled. Unfortunately, the Central Bank had provided that assistance at a rather high cost in quasi-fiscal losses, which it was essential to bring to an end. Therefore, he welcomed the indication in the staff report that central bank operational losses were to be eliminated in 1986. In particular, he welcomed the commitment to eliminate the preferential exchange rate subsidy on eligible foreign debt of $50,000 or more by the end of 1986 and the swap subsidy by February 1987.

In the external sector, the 1985 current account deficit had been limited more or less to the $1.3 billion projected, despite a substantial worsening in the terms of trade in 1985, Mr. Templeman stated. Unfortunately, that deficit was still more than 8 percent of GDP. However, the very sharp real effective depreciation of the peso in 1984-85 and the cut in the uniform tariff rate should greatly improve Chile's international competitive position over the medium term. Substantial export growth would be critical both to overall economic growth and to reducing high debt and debt service ratios. In that connection, he endorsed the commitment of the Government not to guarantee private sector foreign debt beyond the debt involved in the recent rescheduling agreement with commercial banks. He also endorsed the policy of shifting away from dependence on borrowing from foreign banks in favor of borrowing from multilateral lending institutions, although continued dependence on foreign lending of any kind continued to raise delicate issues, as highlighted by the staff's medium-term scenarios and sensitivity tests. Even the achievement, under Scenario 1, of a moderate 3 percent economic growth rate through the end of the decade would result in a debt/GDP ratio of more than 104 percent in 1990 and a debt service ratio of nearly 62 percent of exports. The debt ratio would actually peak at 124 percent of GDP in 1987. The desire for a higher rate of real growth--perhaps 4-4 1/2 percent under Scenario 2, based on additional gross borrowing of about $1.2 billion in 1987-90, was understandable. But the staff, probably correctly, had raised questions about whether capital inflows on that scale could be obtained. Furthermore, the sensitivity analysis suggested that, with a lower copper price, or with a combination of a lower copper price and higher interest rates, real growth could become negative and the debt service ratio rise to as much as 68 percent in 1990.

In conclusion, Mr. Templeman considered that the Chilean authorities had been managing a delicate economic situation quite well so far under the extended arrangement, both with respect to financial policies and the pursuit of structural policies that could help to improve the prospects for faster growth and a more sustainable external position.

Mr. Foot remarked that during 1985 Chile had made considerable progress toward achieving the objectives of its economic program, despite extremely adverse domestic and external conditions largely beyond the authorities' control. All performance criteria at the end of 1985 seemed to have been observed. Fortunately, the technical problems associated with the commercial banks' financing arrangement had been resolved, as a result, incidentally, of the flexibility of two European banks in coming to an agreement.

The program agreed for 1986 seemed broadly appropriate, Mr. Foot considered. He had only one main concern--namely, that the current account target for 1986 was perhaps not ambitious enough. He recognized that progress in reducing the deficit had been hampered by a deterioration in the external environment and that a comparison of 1986 and 1985 must take account of the one-time benefit in 1985 from the reprogramming of interest payments. Nevertheless, it was disappointing that no further reduction in the deficit was expected in 1986, particularly since the medium-term balance of payments projections, which fully reflected the more adverse external environment, still envisaged a significant narrowing of the deficit after 1986. The statement by the staff on page 31 of EBS/86/20 that "the achievement of the targeted current account deficit after the present program year may require a more restrictive policy stance than envisaged at the time of the program's inception" suggested to him that the 1986 program could have been a little more ambitious. He had also noted that provision had been made for only a rather small increase in external reserves. Staff comment on those points would be helpful.

A significant reduction in the current account deficit was essential if Chile's debt servicing problems were to be relieved, Mr. Foot continued. As other Directors had already said, it was a matter for concern to discover that scheduled debt service payments in 1986 would once again entirely exhaust Chile's export earnings, and that the debt to GDP ratio would rise once more. In the latter respect, he welcomed the scheme to permit private residents and nonresidents to purchase selected external claims on Chilean public and private debtors. He asked whether the staff had any idea how the scheme might develop and what its potential impact on Chile's external debt might be. According to the staff report, the monthly flows had been modest so far, and further information would be helpful.

The external projections, as in a number of recent staff papers on other countries, were based on the assumptions in the most recently published World Economic Outlook, Mr. Foot observed. He would be interested to know what procedures the staff was expected to follow when there were major changes in commodity prices, as with oil; for Chile, the most relevant price would presumably be that for copper. Obviously, there had to be consistency between programs, but the difficulty arose in achieving it in a rapidly changing external environment.

Continuing export diversification was clearly crucial in establishing a viable external position, Mr. Foot added, and he welcomed the authorities' commitment to maintaining a competitive exchange rate. However, to judge from the continued existence of a premium in the parallel foreign exchange market, there was still a need for further depreciation. He asked the staff to indicate when and under what circumstances it expected the parallel market premium to disappear.

The authorities' fiscal policy had led, as planned, to a quite remarkable recovery in public sector savings in 1985, Mr. Foot observed. He joined others in welcoming the expected disappearance of the operating losses of the Central Bank. The establishment of a Copper Compensation Fund also seemed prudent. Yet private savings, while higher than expected, remained substantially below what they had been even in 1983. The intention to maintain positive real interest rates and, perhaps more important, further measures to increase confidence in the financial system would be important if private savings were to return to recent levels. The recovery in private investment also lagged behind the recovery in the public sector. Indeed, the former had fallen as a proportion of GDP despite the various tax incentives introduced. He wondered whether any other measures to encourage private investment were planned.

To conclude, Mr. Foot said that he could support the proposed decision, including the waiver and modification. However, while welcoming the commitment to eliminate by end-1986 the subsidy on pre-August 1982 debt service payments, he was not particularly happy with either the postponement of the next increase in travel allowances or the waiving of the intermediate reduction in the minimum financing requirement for imports. On the other hand, the authorities had gone beyond what had been agreed originally in the area of tariff reductions, and he was therefore prepared to give the authorities the benefit of the doubt and approve the proposed decision as a whole.

Mr. Leonard considered that the program undertaken by the Chilean authorities under the extended arrangement approved in July 1985 had struck a good balance between demand restraint and the promotion of structural adjustment. Six or seven months later, the authorities were to be commended for their close adherence to the program. In particular, they had been able to keep a firm grip on domestic demand, to reduce the tariff level, to effect reforms in the domestic financial markets and to improve external competitiveness by continued exchange rate flexibility and pay restraint. As a result, there had been a significant increase in export volume and a sharp reduction in imports in 1985. Despite a further deterioration in the terms of trade, therefore, both the current and overall external accounts had improved markedly, with the exceptions already noted during the discussion; all performance criteria in the extended arrangement had been met.

Because of the difficulties that faced Chile both in the current year and over the medium term, the same general thrust of policy would have to be maintained in 1986, Mr. Leonard continued. The gains already made needed to be consolidated and the basis laid for further economic growth, lower inflation, and better external balance. But policy had to be conducted in an uncertain environment and might have to be adapted accordingly. To the extent that Chile's economic prospects were highly dependent on such factors as copper prices and international interest rates, the authorities should be ready to tighten domestic demand should the external environment show signs of deterioration. And in the event of any improvement in the trading environment, they might take advantage of it to raise official reserves by even more than envisaged at present.

The maintenance of adjustment in 1986 would depend crucially on the further reduction of the public sector deficit, which would help to lessen the external financing requirement while allowing more domestic resources to be directed toward private sector investment, Mr. Leonard observed. In that connection, the intended significant reduction of government expenditure as a proportion of GDP was most desirable, as was the Government's exercise of pay restraint, which would contribute to the momentum of the previous year's drive toward reduced inflation and enhanced external competitiveness. Current revenue was projected to fall, as a percentage of GDP, to the lowest level since at least 1982 because of a reduction of import tariffs ahead of the original schedule and the implementation of the third year of the tax reform program. While in no way retreating from the aims of tax reform as a means of stimulating private saving and investment, the authorities would have to manage the process carefully so that it did not lead to undue losses of revenue or prejudice the overall financing requirements of the public sector. With that in mind, he could support the Government's intention to sell shares of selected public entities not involved in strategic sectors of the economy, thereby reducing the public sector deficit even more, to the extent that such sales were not offset by new lending to the private sector.

In the monetary and financial area, the current stance of policy, which provided for positive real interest rates that were mainly determined by market forces, appeared appropriate, Mr. Leonard considered. He also encouraged the authorities to proceed with the elimination of subsidies granted at present through the preferential exchange rate and the interest rate for swaps. Such action would reduce the operational losses of the Central Bank, a crucial step in the restoration of the Bank's ability to conduct more effective monetary policy.

Chile's external problems remained formidable, Mr. Leonard noted. The debt burden would remain onerous, the indication being that even by the end of the current decade the ratio of external debt to export receipts would remain close to 300 percent, the ratio of interest payments alone being around 30 percent. In those circumstances, and apart from the issue of Chile's possible access to increased foreign borrowing, given current conditions in international financial markets, policy must focus on reducing dependence on foreign capital. Therefore, he agreed with the staff that the authorities needed to monitor external developments very closely to ensure that the necessary exchange rate and other action to avoid a weakening balance of payments was taken. Chile's efforts to shift financing from foreign bank loans to credits from multilateral and official sources were in the right direction and should help to ease the debt burden. So too should the mechanism introduced by the Central Bank to allow private residents and nonresidents to purchase selected external claims on Chilean public and private debtors.

Strong supply-side measures were an indispensable medium-term complement to the authorities' management of demand, Mr. Leonard observed. Over the years, Chile had successfully reduced its reliance on copper exports through diversification, a course that would have to be pursued vigorously if its export goals over the next several years were to be met. The authorities' overall development strategy, which the World Bank was helping to shape, should be helpful in that connection. He had noted in particular the World Bank's assessment that the public investment program included high return and well justified projects that were fully conducive to improving economic efficiency and accelerating exports. The creation of the Copper Compensation Fund, which had been established as part of the structural adjustment loan granted by the World Bank, also appeared likely to contribute toward smoothing out the effects of fluctuations in the price of copper on the economy in general and on the performance of the public sector in particular.

Finally, Mr. Leonard stated that his chair supported the proposed decision while strongly urging the authorities to proceed forcefully and expeditiously to abolish multiple currency practices and exchange restrictions.

Mr. Goos remarked that as he was in broad agreement with the staff appraisal his comments would be rather brief, particularly since other Directors had already addressed in great detail the critical areas of Chile's adjustment effort, most notably the need to sustain a cautious financial policy stance combined with continued efforts to reduce the high dependence on foreign borrowing.

Like others, he was pleased to note that the authorities had been quite successful so far in implementing their stabilization effort, Mr. Goos continued, as shown by the fact that developments seemed to be broadly in line with the original objectives of the program and by the observance of all the performance criteria as of December 1985. It was particularly reassuring to note, as stressed by Mr. Nebbia in his statement, that the authorities had been able to keep the program on track despite unexpected adverse circumstances, above all, by keeping public sector expenditures well below program levels. The authorities' commitment to adjustment, as reflected in the way in which they had responded to those adverse circumstances, appeared to bode well for the future, the more so because the critical process of restructuring the allocation of resources seemed to be well under way. That was evident in the decline in real consumption accompanied by a significant increase in real fixed investment, the strong expansion in export volume, and the sharp decline in imports during 1985. Equally encouraging in that context was the stronger than expected increase of domestic savings. Taken together, those developments pointed in the right direction and would undoubtedly have to be maintained and wherever possible strengthened in order to restore a viable balance of payments position.

The objectives and targets agreed for 1986 seemed to be consistent with that requirement, Mr. Goos added, even though the external targets had had to be relaxed in order to take account of the adverse repercussions of the earthquake and the less favorable external environment. In addition, the fiscal, monetary, and exchange rate policies envisaged for 1986 should be adequate to maintain the momentum of adjustment. However, he wished to associate himself with the staff's concern about the continuing high debt service ratio, which in the face of the uncertain prospects for future external borrowing and external economic developments clearly pointed to the need to monitor developments closely and to stand ready to take the necessary action to correct any program slippages without delay.

In concluding, Mr. Goos said that he welcomed the World Bank's close association with Chile's adjustment effort. In that respect, he wondered whether the report of the World Bank's public investment review mission, which had visited Chile in November 1984, had been finalized, and what conclusions could be drawn from that report. He supported the proposed decision, including the proposed modification and waiver.

Mr. Huang stated that in view of the considerable progress made by the Chilean authorities in achieving the objectives of their program during 1985; in light of the staff's satisfactory appraisal of Chile's economic performance; and in recognition of the ability and determination of the Chilean authorities, as expressed in Mr. Nebbia's statement, his chair had no difficulty in supporting the proposed decision.

Mr. Fujino recalled that the extended arrangement for a three-year period had become effective on August 15, 1985 with the confirmation of the necessary balance of payments financing from commercial banks. At the time of the Executive Board discussion, the renewed and strengthened adjustment efforts of the Chilean authorities had been generally endorsed, and the final agreement on November 1, 1985 on the provision of new money by the commercial banks had indicated the general support of the international community for their efforts.

It was gratifying to note that in the meantime considerable progress had been made toward achieving the basic objectives of the economic program, as highlighted in Mr. Nebbia's statement and by the end-December quantitative performance criteria, which, according to the staff, had been observed, Mr. Fujino continued. Among the encouraging signs of sustainable future growth in the economy, the volume of noncopper exports had increased by 6 percent in 1985, and there had been a significant increase in gross capital formation in real terms. Reflecting those favorable developments in the domestic economy and the cooperation of the international community, the balance of payments projection for 1986 could be expected to be attained. He had noted from page 15 of the staff report that the inflow of capital to the private sector had fallen short of the projection by $135 million, having been offset by a short-term capital inflow, including a drawdown of private assets abroad in 1985. A further explanation by the staff of the reason for and nature of those developments would be helpful.

But at the same time that those promising developments were being witnessed, Mr. Fujino commented, the external conditions surrounding the Chilean economy had deteriorated further. The terms of trade had worsened, with lower copper prices, and the prospects for their reversal in the immediate future were very dim. The staff's medium-term scenarios contributed toward an understanding of the problems to be faced by the Chilean economy in the years to come. The high ratio of Chile's external debt to GDP made it imperative for the authorities to continue policies aimed at reducing foreign borrowing, as the staff had rightly emphasized.

In that respect, as many other Directors had mentioned, closer collaboration with the World Bank would be essential to define investment priorities and to channel resources to their most efficient use, Mr. Fujino said. The World Bank's decision to extend a structural adjustment loan and its judgment that Chile's investment program included high return and well justified projects was reassuring. The appendix to the staff report on the status of World Bank group operations in Chile was most helpful in explaining those operations and the World Bank's view.

A realistic exchange rate policy would be instrumental to maintaining competitiveness in industry, especially in the short run, Mr. Fujino concluded. The continuation of daily adjustments of the rate should be monitored carefully so that the momentum of the present favorable trend was not lost. The creation of a futures market was a welcome innovation for reducing the risk arising from exchange rate fluctuations. Options on futures markets were however more risky than forward market operations, and he wondered why the authorities had chosen that type of hedging. Comment by the staff would be helpful. Finally, he could generally endorse the staff appraisal and he supported the proposed decision setting the performance criteria for 1986 and requesting a modification and a waiver.

Mr. Romuâldez noted that Chile's progress in 1985 had been remarkable. Besides complying with all performance criteria--the target for net international reserves and the commitment to increased travel allowances having been observed a few months late, for reasons beyond the authorities' control--the authorities' policy and practice throughout the year just ended had been characterized by restraint and prudence. Economic activity might not have grown as rapidly as programmed but unemployment had declined. Export volume had increased faster than projected, as had domestic savings and gross capital formation. In spite of deteriorating terms of trade, the external current account deficit had been broadly as programmed. External competitiveness had been maintained, with some flexibility and realism in the exchange rate. The inflation rate had veered only slightly off target. Fiscal responsibility had prevailed, and the public enterprises had contributed in no small measure to the strengthening of public finances. Debt management had been firm and tinged also with imagination. Chile's prospects for 1986 and for the years beyond continued to pose a challenge, given the deteriorated terms of trade and high debt service ratios. The economy therefore remained vulnerable and the need to maintain adjustment remained unchanged.

In the light of those considerations, his chair welcomed the structural adjustment efforts with respect to the tax and financial systems and the administration of government finances, Mr. Romuâldez said. The export diversification effort had to be sustained, of course, and even intensified. Particularly welcome was the World Bank's support, through both the structural adjustment loan and technical assistance. The increased complementarity--not just cooperation--of Bank-Fund actions had become more and more evident in recent staff papers on Fund-supported programs, a most welcome development. The authorities' commitment to the pursuit of policies of adjustment, designed especially to reduce dependence on external borrowing, and with as much rigor as their currently unfavorable economic environment required, was reassuring. He agreed fully with the authorities, as with the staff, that some priority must be given to further reducing the deficit of the nonfinancial public sector. He was confident that Chile would succeed in that effort: the authorities' performance to date left little room for doubt in that respect. He supported the proposed decision.

Mr. Orleans-Lindsay said that he supported Chile's request for a modification and waiver of its extended arrangement.

The staff representative from the Western Hemisphere Department said that an important consideration in analyzing the level of national savings, which, as Directors had mentioned, was relatively low, was that the domestic savings--which included payments of interest abroad--had in fact approached 17 percent of GDP in 1985; in that year, national savings and domestic savings alike had increased significantly in comparison with the preceding year even though Chile's terms of trade had deteriorated and adversely affected the ability of the economy to generate domestic savings. The authorities and the staff were being very prudent in their assessment of the level of savings for 1986--in the context of the adjustment process--savings being a residual in the national accounts methodology of Chile.

Although investment was projected to be higher in 1986 than in 1985, the staff representative added, the projections for investment contained in the program were modest ones. Recent indications, which were not reflected in the staff report, suggested that private sector confidence had been growing, leading to an increase in investment in recent months, and suggesting also that national savings had increased, since the original projections for the current account had not changed. The encouragement of private investment was inherent in the set of policies being pursued by the Government with the aim of creating the framework for stable growth. By ensuring positive real returns to capital, providing a predictable and stable set of rules for exchange rate management, and taking strong action to correct imbalances in the public sector, including the losses of the Central Bank, the authorities hoped to create the environment for private sector participation in the economy.

As for fiscal policy, it should be noted that the reduction in import duties over the past year, ahead of schedule, had led to an initial shortfall in revenue that had had to be offset by a combination of other revenue and expenditure measures, the staff representative explained. The overriding consideration for the reduction in import duties had been to improve the allocation of resources, thereby creating the conditions for more sustained growth with respect to both the export and the import substituting sectors. The reduction in business-related taxation had been fully implemented, but the proposed reduction in personal income taxes had become only partially effective, the full reduction having been postponed until 1987 on account of the trade-off between revenue and resource allocation considerations.

With respect to the quasi-fiscal deficit of the Central Bank, for purposes of the review, the staff had maintained its initial approach, namely, that although the ability to measure the losses of the Central Bank had improved greatly, an effective monitoring mechanism had not yet been devised, the staff representative added. Therefore, the program had been formulated on the basis of targets for the public sector deficit, on the one hand, but on targets or objectives that did not constitute performance criteria with respect to the elimination of the operational losses of the Central Bank on the other. The main objective was to eliminate the causes for those losses, which would in fact be sharply reduced as a result of the actions to reduce subsidies on interest rates and phase out the preferential exchange rate. As indicated in the staff report, the operational losses would most likely disappear; a small loss would continue to be recorded owing to the gradual elimination of the subsidies, but the Central Bank would record some profits on other operations. In 1985, the Central Bank's losses had increased largely as a consequence of the authorities' decision to depreciate the real exchange rate for the Chilean peso because of the conditions prevailing in external markets, leading to a corresponding increase in the subsidies related to the preferential exchange rate. Finally, the ultimate but indirect mechanism for controlling the losses of the Central Bank was through the usual limit on the Central Bank's net domestic assets, which would incorporate those losses, requiring the authorities to take offsetting measures.

While the elimination of the Central Bank's losses would probably have a direct impact on private sector savings, as Mr. Ortiz in particular had noted, from a purely statistical point of view private sector savings, as shown in the staff report, included the financial system as a whole; accordingly those losses were effectively being offset, the staff representative noted. In addition, since one of the objectives of the program was to increase credit to the private sector, the reduction of the Central Bank's losses would not be allowed to pre-empt such credit, which would be made available to the private sector but at positive, realistic interest rates. Information on interest rates would normally have been incorporated in the staff reports or reports on recent economic developments prepared in connection with Article IV consultations. In general terms, average real rates on deposits in 1985 had been 4 percent, compared with 2 percent--with the exception of certain short periods--in 1984; the average real rate on deposits had been 2.3 percent in 1984 and 4.2 percent in 1985.

Domestic liabilities denominated in foreign currencies did not constitute an important proportion of total liabilities in Chile, the staff representative noted.

In designing the original program targets, an attempt had been made to take into account the external conditions prevailing at the time, the staff representative recalled. In 1985, Chile had experienced a severe earthquake, which had had significant economic costs. The current account target for 1986 reflected both the need for reconstruction as a result of the earthquake, and improved expectations for private sector investment. In any event, the policies implied in the program for 1986 were tighter than those that had been envisaged when the program had been put in place in the middle of 1985.

The uncertainties surrounding Chile's economic performance in 1985, related in part to the deterioration in its terms of trade, had resulted in somewhat lower direct foreign investment, the staff representative from the Western Hemisphere Department explained. At the same time, Mr. Orleans-Lindsay said that he supported Chile's request for a modification and waiver of its extended arrangement.

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The uncertainties surrounding Chile's economic performance in 1985, related in part to the deterioration in its terms of trade, had resulted in somewhat lower direct foreign investment, the staff representative from the Western Hemisphere Department explained. At the same time, balances held abroad by the Chilean private sector had been repatriated in response to attractive rates of return and new opportunities for investment. Consequently, although direct investment had revived slowly, short-term inflows had shown a prompt response to improved economic conditions, as reflected in the balance of payments.

The medium-term outlook for Chile remained uncertain, the staff representative added. The authorities would have to maintain cautious economic policies in order to achieve the necessary reduction in the current account deficit as the only way to reduce their external debt burden. The achievement of the necessary adjustment was a matter of great concern to the authorities, who had indicated their commitment to pursuing a prudent fiscal and financial stance, within a framework that would promote private sector investment over the medium term. The projections in the staff report reflected that commitment. Of course, there was no fixed relationship between the current account and growth. Therefore, several strategies had been mentioned in the staff report for the external sector that would provide the resources necessary for growth, subject to certain limitations in the short run related to the restrictive financial stance that would affect growth prospects for one or two years.

The spread between the exchange rate on the parallel market and the official rate, which had widened to 20 percent by October 1985 because of uncertainties related to the completion of the agreement with commercial banks, had been declining consistently since that time, the staff representative noted. The spread between the two rates had been about 7 percent during the past few months.

The review of the public sector undertaken by the World Bank had not yet been formally finalized, the staff representative commented, although its conclusions had been built into the structural adjustment loan approved in October 1985. The review of public sector investment would be updated when the second structural adjustment loan was negotiated.

Under the procedure for the purchase of private and public sector external obligations by the Chilean private sector, the staff representative explained, the Central Bank authorized on a monthly basis and under an auction system a certain amount of debt that could be purchased in the secondary market abroad; the Central Bank charged a small fee for registering them. So far, the monthly authorization had averaged about $20 million for Chilean residents.

In response to questions by the Chairman, the staff representative noted that the scheme had been used mostly by Chilean residents seeking to repay debt with the domestic banking system; they obtained a significant profit in doing so because the discount on the external claims, although it varied, averaged about 30 percent. Chilean residents did not have access to the official exchange market for the scheme; therefore, they had either to use their holdings of foreign exchange abroad or purchase exchange on the parallel market, at a discount of 7 percent. For the six months during which the scheme had been in operation in 1985, registrations by nonresidents had totaled $30 million; in January, an additional transaction of $55 million had been registered, indicating greater interest.

The scheme had been devised to take advantage of the situation that had developed in international capital markets and at the same time to make it easier for Chilean residents to buy such claims at a discount, the staff representative from the Western Hemisphere Department added. The amount had been limited, first, because the scheme was experimental; and second, to avoid pressure on the parallel market rate that might have resulted from a significant movement of funds through that market. There would have been no initial impact on official reserves but the process of leakage between transactions on the official and parallel markets could have had an adverse impact on expectations and on economic management in the short run.

The Chairman said that it would be interesting to learn more about the scheme, which was one of the most innovative ways of treating debt that had been introduced in recent years. Both residents and nonresidents were in effect being encouraged to purchase Chilean debt by the discount on the market, and by the possibility of transforming such debt into equity at par.

Mr. Templeman agreed that the scheme was interesting and that other countries might wish to consider applying it. The matter of secondary markets could perhaps be discussed in the forthcoming seminar on debt and in staff reports on international capital markets.

The staff representative from the Western Hemisphere Department, in response to a further question by the Chairman, commented that Chilean residents had shown some interest in bringing money back into the country, as reflected in short-term flows outside the Central Bank's scheme. Apparently, a number of private enterprises or individuals who managed to negotiate mutually convenient settlements that offered them even greater discounts were making purchases of external debt outside the scheme. There was nothing to prevent Chilean residents from purchasing discounted claims abroad, on their own account. In any event, the amount of external debt, strictly defined, was thereby reduced; however, it could be said that the amount of debt denominated in foreign currency remained unchanged but became debt denominated in foreign currencies between residents.

The Chairman suggested that it might be useful for the staff to prepare a paper on such schemes and their use.

Mr. Fujino remarked that it would indeed be encouraging if an inflow of capital was taking place as a result of purchases outside the Central Bank's scheme. He recalled that he had asked why the authorities had chosen to authorize a private futures market in foreign exchange, a complex and risky operation.

The staff representative from the Western Hemisphere Department responded that as Table 6 showed, there had been a signficant outflow of capital in 1982-83, a period of growing uncertainty, but a reversal had begun already in 1984 and had continued in 1985. It was important to bear in mind that part of the capital inflow in those two years might have been related to the subsidy schemes. However, although the authorities had announced in mid-1985 that subsidies on interest rates and the preferential exchange rate subsidy would be eliminated, capital inflows remained high.

The Chilean authorities saw no significant difference between a futures and a forward market, considering that the former was more appropriate in Chile's circumstances, the staff representative added. The staff view was that Chile's financial system was sufficiently sophisticated to manage a futures market, which was what the commercial banks and the private sector had been seeking to obtain from the authorities. One important advantage to the authorities was that the Central Bank would be able to leave the operation of the futures market to commercial banks without having to intervene itself in any way. Although there was always a risk of intervention in either futures or forward markets, the authorities had wished to indicate their intention not to intervene while establishing what they considered to be an appropriate mechanism.

The Chairman noted that Table 6 indicated a negative swing in errors and omissions of $200 million--from $107 million in 1984 to a projected -$103 million in 1985--suggesting the possibility of capital outflows. Direct investment also continued to be low in comparison with earlier years.

The staff representative from the Western Hemisphere Department noted that the possibility of capital outflows could not be excluded. Direct investment had been disappointing to the authorities and to the staff as well. The decline in such investment was related to uncertainties with respect to economic management and the prospects of the Chilean economy in 1984, which had carried through into 1985. The staff understood that the trend was improving, with direct investment likely to exceed the modest estimate of $110 million for 1986, but the authorities nevertheless considered it appropriate to take a cautious view in that respect.

The Deputy Director of the Exchange and Trade Relations Department remarked that the number of performance criteria, to which Mr. Almeida had referred, was the number that had appeared necessary in order to follow up the implementation of the program.

As for the Central Bank's scheme for the transformation of external debt into equity, its effectiveness would depend on the existence of a market price that would encourage such transfers, the Deputy Director commented. Certainly, such schemes could help debtor countries to deal with their debt problems.

One hurdle in bringing about the transformation of debt into equity might arise if the holders of Chilean debt considered that the discount at which that debt would have to be sold was too large, the Deputy Director noted; to the extent that Chile's adjustment effort was perceived as strong and sustained, that perception was likely to lead to relatively small discounts, which in turn might limit actual conversions of debt into equity. There was, therefore, a balance to be struck between the strength of the adjustment and the likely scope of the conversion scheme. The Chilean authorities were pursuing a proper strategy by continuing with their adjustment and facilitating the process of changing the composition of capital movements so that the desired improvement in the balance of payments could take place on a sustained basis.

The thrust of the discussion in the Board had been that Chile's policies were appropriate but that its economy remained vulnerable, the Deputy Director of the Exchange and Trade Relations Department commented. There had been concern already over the vulnerability of the economy--because of Chile's great dependence on copper export receipts--when the previous two-year stand-by arrangement had been approved in 1983. With the large accumulation of foreign debt, such vulnerability had increased. In broad terms, the authorities' present policies were appropriate but the medium-term prospects and situation still posed complex problems. The solutions would have to include a further reduction in current account deficits supplemented by some change in the composition of capital movements. In that connection, the Central Bank scheme for the purchase of external debt was an appropriate move as it allowed the conversion of capital flows from debt to equity and private direct investment. The scope for such conversions appeared ample as indicated by the medium-term projections for direct investment, which were very conservative. In 1982, direct investment had amounted to almost $400 million, whereas for the remainder of the current decade, the projections ranged from about $100 million to just over $160 million.

Mr. Nebbia said that he would convey the views of Executive Directors to his authorities. He had taken note of the general satisfaction with the program and the firm stance taken by the Chilean authorities with respect to both demand management and structural adjustment.

On the debt issue, Mr. Nebbia stated that his authorities were well aware of the current and projected development of the main indicators, including the ratio of debt to GDP and of the debt service to export receipts. That awareness had been translated into special measures and into the firm commitment of the authorities to reduce reliance on foreign financing through the pursuit of a flexible exchange rate and by maintaining an external sector that was free of restrictions. In turn, results were being yielded in terms of greater efficiency, better resource allocation, and above all, by an increase in Chile's competitiveness in foreign markets. In addition, the shift noted by a number of Directors from borrowing from commercial banks through borrowing from multilateral institutions and official sources would certainly contribute to improving the structure of the debt as well as its maturity.

As for directing a further increase in domestic savings toward the payment of debt service, Mr. Nebbia added, the staff had clearly highlighted the limits of that source of financing and its high opportunity cost in terms of economic growth. It would be prudent to keep in mind that the current account deficit of $1.3 billion was a reflection of interest payments abroad amounting to about $2 billion, or almost two thirds of expenditures on imports.

The adjustment incorporated in the program for 1986 continued to be vigorous, Mr. Nebbia observed, and was in line with the final goal envisaged when the extended arrangement had been approved. More ambitious adjustment might jeopardize the whole program. As Directors had recognized, Chile's situation would pose a significant challenge in the years ahead. Even if the current account target was not the optimal one, given the high rate of debt to GDP, it was considered by his authorities to be realistic, and every effort would be made to meet it.

The Chilean authorities recognized the potential of the scheme that had been introduced recently to reduce external indebtedness, but were proceeding very cautiously, Mr. Nebbia explained. Their primary concern was to ensure that the economy was in equilibrium, and before introducing or extending the scope of ambitious schemes, they wanted to be sure how they would work and what the implications would be for the economy as a whole.

The Executive Directors then took the following decision:

1. Chile has consulted with the Fund in accordance with paragraph 4(b) of the extended arrangement for Chile and paragraph 4 of the letter of July 9, 1985 attached thereto (EBS/85/122, Sup. 3).

2. The letter dated January 20, 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 letter dated July 9, 1985, together with the annexed Memorandum on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated January 20, 1986, together with the annexed memorandum on economic policies.

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 Table 1 of the memorandum annexed to the attached letter of January 20, 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 Table 2 of the memorandum annexed to the attached letter of January 20, 1986, is not observed, or

(c) during any period in which the data at the end of the preceding calendar quarter indicate that the net international reserve target, as specified in Table 3 of the memorandum annexed to the attached letter of January 20, 1986, has not been met, or

(d) during any period in which the continuous ceiling on the stock of short-term foreign debt owed by the nonfinancial public sector and the Banco del Estado, as specified in Table 4 of the memorandum annexed to the attached letter of January 20, 1986, is not observed, or

(e) during any period from July 1, 1986 to September 30, 1986, if the data as of June 30, 1986 indicate that the limit on the stock of short-term foreign debt owed by the nonfinancial public sector and the Banco del Estado established for that date as specified in Table 4 of the memorandum annexed to the attached letter of January 20, 1986, is not observed, or

(f) during any period in which the continuous ceilings or subceilings on the contracting and guaranteeing of medium-term 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 attached letter of January 20, 1986, are not observed.

4. The intention with regard to the increase in travel allowances specified in paragraph 4(a)(viii) of the extended arrangement and in the fifth sentence of paragraph 34 of the letter of July 9, 1985 shall be modified in accordance with the last sentence of paragraph 31 of the memorandum annexed to the attached letter of January 20, 1986.

5. The Fund decides that no further understandings are necessary and that Chile may proceed to make purchases under the extended arrangement notwithstanding that the intention to reduce the deferment period for import payments by December 1985 contemplated in paragraph 4(a)(viii) of the arrangement was not carried out.

Decision No. 8208-(86/39), adopted
February 28, 1986

3. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION TO LIMIT USE OF FUND RESOURCES.

Mr. Mtei recalled that when the Executive Board had considered the report and complaint of the Managing Director relating to Sierra Leone's overdue financial obligations to the Fund on January 6, 1986 (EBM/86/3), it had been agreed that a further review would take place not later than March 5, 1986, taking into account further developments. The Sierra Leonean authorities had been in constant touch with the staff and management since that time and a mission was currently in Freetown discussing the matter of how Sierra Leone could become current in its financial obligations. In order to allow sufficient time for the measures being proposed by the Sierra Leonean authorities to be assessed, and because he would not be in Washington during the week beginning March 3, he asked whether the Executive Board could agree to postpone the review of Sierra Leone's overdue financial obligations for one week, from March 5 to March 12.

Mr. Foot said that he could certainly go along with Mr. Mtei's proposal. However, he wished to make several related points. First, scheduled Board meetings should not normally be postponed solely because a staff mission had lasted longer than was intended. Moreover, both the authorities concerned and the staff mission and management were assisted in organizing their work when a firm date was set for a Board meeting. Another factor to be borne in mind was that the Executive Board's tentative schedule was already very full during the week in question. Therefore, the proposed postponement, although it was acceptable to him, should not establish a precedent, for the reasons he had indicated.

Mr. Goos and Mr. Templeman said that they concurred with Mr. Foot's remarks.

Mr. Leonard said that he assumed that the discussions between the staff and the authorities were with the Government that had taken office shortly before the end of 1985.

Mr. Mtei confirmed that Mr. Leonard's understanding was correct.

Mr. Huang, Mr. Nebbia, and Mr. Romuáldez also supported Mr. Mtei's request for a one-week postponement.

The Executive Board then took the following decision:

Paragraph 4 of Decision No. 8174-(86/3), adopted January 6, 1986, and relating to the further review of Decision No. 8014-(85/101) G/TR, adopted June 28, 1985 pertaining to Sierra Leone's overdue financial obligations to be held not later than March 5, 1986 shall be amended by substituting March 12, 1986 for that date.

Decision No. 8209-(86/39), adopted
February 28, 1986

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/38 (2/27/86) and EBM/86/39 (2/28/86).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/46 (2/26/86) is approved.

APPROVED: October 29, 1986

LEO VAN HOUTVEN
Secretary