MASTER FILES

ROOM C-120 04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/106

10:00 a.m., July 15, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
C. H. Dallara	
	L. Hubloue, Temporary
	S. de Forges, Temporary
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	
R. K. Joyce	
	H. A. Arias
H. Lundstrom	
E. I. M. Mtei	
F. L. Nebbia	
	J. E. Suraisry
P. Pêrez	G. Ortiz
J. J. Polak	
C. R. Rye	
	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: L. E. Derbez, Latin American and the Caribbean Regional Office. Exchange and Trade Relations Department: M. Guitián, Deputy Director; P. A. Molajoni, M. H. Rodlauer. External Relations Department: H. P. Puentes. Middle Eastern Department: A. Ouanes. Research Department: N. M. Kaibni, H. C. Kim, E. C. Meldau-Womack, T. K. Morrison, A. Mullor-Sebastian. Western Hemisphere Department: E. Wiesner, Director; P. D. Brenner, L. E. Escobar, H. M. Flickenschild, J. Jaramillo-Vallejo, C. M. Loser, C. G. Muniz B., J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, D. Hammann, J. Hospedales, H.-S. Lee, G. Nguyen, M. A. Weitz. Assistants to Executive Directors: J. de la Herrán, V. Govindarajan, G. D. Hodgson, O. I. Isleifsson, K. Murakami, D. J. Robinson, C. A. Salinas, M. Sarenac, A. A. Scholten, L. Tornetta, E. L. Walker, B. D. White.

1. CHILE - 1985 ARTICLE IV CONSULTATION, EXTENDED ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1985 Article IV consultation with Chile and the request for an extended arrangement in an amount equivalent to SDR 750 million (EBS/85/122, 5/13/85; and Sup. 1, 7/12/85) together with a request for a purchase in an amount equivalent to SDR 70.6 million under the Decision on Compensatory Financing of Export Fluctuations (EBS/85/124, 5/13/85; Sup. 1, 7/12/85; and Sup. 2, 7/12/85). They also had before them a report on recent economic developments in Chile (SM/85/150, 5/24/85).

Mr. Nebbia made the following statement:

As mentioned in the staff report, adjustments in the Chilean economy have been implemented since mid-1982, when important policy corrections were applied in response to adverse external developments. Faced with a sharp decline in demand and prices for Chile's main export commodities, increased net payments abroad, a substantial reduction in net capital inflow, and a progressive appreciation of the Chilean peso, the authorities decided, at that time, to devalue the peso after three years of fixing it against the U.S. dollar, to remove mechanisms of wage indexation to past inflation, and to adopt a number of measures to cope with an emerging fiscal deficit. Notwithstanding the positive effects of these measures toward restoring domestic and external balance, the severity of the adjustment implied that during 1982 real GDP fell by 14 percent, real wages declined by almost 13 percent, and unemployment rose to 20 percent. On the other hand, and in spite of the decline in exports, the trade balance shifted from a deficit of US$2.7 billion in 1981 to a surplus of US$60 million in 1982, while the current account deficit was reduced to a figure less than one half of that in the preceding year.

In this setting, in late 1982 the authorities framed an economic program for 1983 and 1984, for which Fund support was requested and granted under a stand-by arrangement.

As correctly noted by the staff, the objectives of the program were to achieve an improved balance of payments performance as well as low inflation, with a view to restoring confidence and economic growth. Performance during the first year of the program was more than satisfactory. Despite problems at the beginning, due to a major crisis of privately owned financial institutions, which in turn led to a sharp decline of the Central Bank's net international reserves, Chile was able to return to the path of the economic program, and to successfully conclude its negotiations with foreign commercial banks, to obtain fresh resources, to refinance maturities for 1983 and 1984, and to secure a substantial amount of short-term trade credit.

In spite of a still negative real GDP growth for 1983--minus 0.7 percent--the signs of economic recovery began to appear around midyear, and by the last quarter of 1983 real GDP was 6.4 percent above the corresponding quarter of 1982. The authorities also succeeded in keeping inflation below the programmed level of 25 percent, and unemployment was reduced to less than 15 percent. On the other hand, real wages experienced a further decline of about 4 percent, with real consumption being 14 percentage points below its 1981 level, while public sector operations registered a slight reduction of the overall deficit, from 3.4 percent of GDP in 1982 to 3.0 percent in 1983.

In addition, financial stability was strengthened, stemming the loss of international reserves, and at the same time, the trade balance surplus increased to over US$1.0 billion, leading to a new meaningful reduction of the current account deficit.

As of 1982, the improved trade position reflected a drastic curtailment of imports and the persistence of the 1981 export levels.

The economic program for 1984 was aimed at fostering economic recovery and strengthening progress achieved in 1983, notably in domestic financial stability. To that end, the program was based on the pursuit of a flexible exchange rate policy, competitive interest rate and wage policies, demand management policies consistent with overall balance of payments equilibrium, an inflation rate of about 20 percent, and a real GDP growth of 4 percent. Chile's performance under the stand-by program was satisfactory and within the limits agreed, except for minor deviations in the ceilings for net domestic assets and net international reserves.

It should be underlined that such compliance was achieved despite extremely adverse and unexpected external developments: a reduction in export prices of 8.4 percent compared with 1983 levels--reflecting a sharp decline in copper prices--and a meaningful increase in world market interest rates.

Nevertheless, real GDP growth reached 6.3 percent for the year, the unemployment rate declined to 14 percent, and the inflation rate remained unchanged from its 1983 level of 23 percent. On the other hand, the overall deficit of the nonfinancial public sector rose to 4.3 percent of GDP, reflecting a somewhat eased fiscal policy during the last quarter of the year.

On the external side, the current account deficit was larger than expected, although still close to the level that had been anticipated for the year, when the stand-by program had been framed in 1982. Accounting for more than 10 percent of GDP, the current account deficit in 1984 reflected a severe deterioration in Chile's terms of trade during the same period, as well as the sharp increase in international interest rates. While the first factor, together with an import surge in response to economic recovery, led to a significant decrease in the trade surplus--less than US$300 million compared with US$1.0 billion in the preceding year--the second implied that net service payments to foreign creditors were US$110 million larger than originally estimated.

In response to these developments, in September 1984 the authorities devalued the peso by 19 percent and designed a medium-term adjustment strategy that forms the basis for the requested extended arrangement. The main objectives of the medium-term economic program are to reduce the external current account deficit while achieving moderate economic growth and slowing inflation.

It also aims to consolidate and further improve the already substantial progress made during the implementation of the preceding stand-by program, particularly regarding the re-establishment of financial stability.

The objective of reducing the external current account deficit is to be pursued gradually through the three years covered by the program. It is projected that the US$2.1 billion deficit registered in 1984 will be lowered to US$1.4 billion in 1985 and to US$1.0 billion by 1987, principally on the basis of a progressive reduction of the quasi-fiscal subsidies of the Central Bank and of the deficit of the nonfinancial public sector.

In addition, the program envisages policies designed to promote exports and efficient import substitution. To that end, it provides for a flexible exchange rate policy and for lower import tariffs. A most recent development in this area, and a very significant export promotion measure, has been the decision adopted by the authorities, late in June, to devalue the peso by 8 percent in order to boost the volume of Chilean exports, and to accelerate the scheduled reductions of the tariff level through a cut of 10 percent, which implies that the uniform tariff level at the end of June 1985 is now 20 percent, that is to say, 5 percent below the programmed figure for June 30, 1986. Some other export promotion measures have been implemented as well, and a further liberalization of Chile's exchange and trade system is also considered within the framework of the program.

Consistent with external policies, the fiscal management for the next three years envisages the total elimination, toward 1987, of the nonfinancial public sector deficit.

Expressed as a percentage of GDP, it is projected that the nonfinancial public sector deficit will be cut back from 4.3 percent in 1984 to 3.0 percent in 1985 and 1.8 percent in 1986, and will be eliminated by 1987. In addition, the reduction of the public sector deficit will be accompanied by a significant increase in public sector savings to help finance priority investment in the public sector.

With that aim the authorities intend to carry out the fiscal adjustment mainly by restraining the growth of general government wages, transfers, and subsidies, since they are strongly committed to an income tax reform to foster private savings and investment. The reform is intended to lower tax rates for enterprises and individuals, provide tax benefits for reinvestment of earnings, and permit deductions for personal savings from taxable income.

On wage policy, it should be recalled that the Government sets the wages for general government civil servants and also the minimum wage, all other wages being determined by collective or individual bargaining.

Wages and salary adjustments granted to civil servants have been restrained in the last four years, and it is the authorities' intention to keep this policy during 1985 and in the years to come. As for 1985, wage increases will be limited to the 14 percent increase granted last January, while inflation is expected to be about 25 percent. Compared with 1981, real wages have declined almost 20 percent until 1984, and a further decline of 8 percent is expected to take place in 1985.

The objectives of the monetary policy envisaged in the economic program are to improve the allocation of financial resources and to strengthen the financial system. To achieve such objectives the authorities intend to limit the scope of the operations of the Central Bank, to reduce the quasi-fiscal subsidies of the Central Bank and thereby its operational losses, to enhance the role of market forces in the determination of interest rates, to recapitalize the financial system, and to improve financial legislation.

The 1985-87 program also calls for a reduction of the subsidies to the financial sector and indebted firms or individuals currently being channeled through central bank operations. In this regard, the authorities have recently announced a gradual phasing out of both an exchange rate subsidy established in 1982 for foreign currency-denominated domestic and external debts and a subsidy associated with swap operations of the financial intermediaries of the Central Bank, according to an 18-month schedule. Given the size of the subsidies now being eliminated, these measures amount to a major step in the normalization of central bank operations.

Regarding the external financing needs that Chile will continue to face during the period covered by the extended arrangement, increased financing from multilateral development institutions and official bilateral sources, as well as the continued participation of the banking community, will remain crucial if the program is to yield all the expected results.

For the period 1985-86, assurances have been received on the rescheduling of principal payments due to official creditors and on the financial support to be provided by the multilateral development institutions, including a structural adjustment loan and a cofinancing arrangement with the World Bank. To complete the financing of the balance of payments for the period 1985-86, the Chilean authorities requested financing from the international banking community equivalent to US$1,235 million and reached agreement with the Steering Committee at the end of last June.

Total financing of the balance of payments for the period 1985-86 will therefore amount to some US$1,955 million, consisting of a new money facility equivalent to US$785 million; the rescheduling of certain bank credits not previously included accounting for US$75 million; a reduction of US$225 million in Chile's interest obligations to foreign commercial banks because of the repricing of some obligations and the deferral of certain interest payments; World Bank cofinancing amounting to US$300 million, of which US$150 million has the guarantee of that institution; an IBRD structural adjustment loan estimated at US$400 million; and refinancing of certain official credit accounting for US$170 million.

The Chilean authorities have repeatedly expressed their conviction that they will have to work closely with the Fund for many years to come, and to that extent, they want to reassure the Executive Board of their intention to continue pursuing orderly and sound domestic policies, such as those successfully implemented under the preceding stand-by arrangement.

The Chilean authorities are confident that the open and straightforward relationship that Chile has maintained with the Fund in the past will be preserved and enhanced. In this spirit, the Chilean authorities would like to request from the Board a positive response to the staff's proposed decisions.

Mr. Arias observed that the effects of the substantial balance of payments adjustment achieved by Chile during 1982-83 had not been maintained during the difficult year of 1984, although progress had been made on the inflation front. In view of the unfavorable prospects for an improvement in Chile's terms of trade, and for growth rates of world output in 1985 and the medium term, the Chilean authorities had developed a three-year program, in support of which they were requesting an extended arrangement with the Fund in the very modest amount equivalent to 170 percent of quota. The small size of the request was justified by the high level of Chile's gross reserves, and he was satisfied that Chile's request for Fund resources would be paralleled by a request for a structural adjustment loan from the World Bank.

While generally in agreement with the staff appraisal of Chile's current situation and prospects, he believed that even the modest anticipated growth of 3 percent might not be realized if the growth rate of imports could not be raised above 3 percent in 1986-87, following the sharp fall that was expected for both oil and non-oil imports in 1985, Mr. Arias continued. That drop was foreseen despite the very large reduction in the volume of imports that had taken place in 1982 and 1983 and that had been only partially compensated for by the sharp growth that had occurred in 1984. Also troubling was the prospect that the program would leave Chile with a relatively high current account deficit in 1987 of roughly 5 percent of GDP. Moreover, the staff had correctly noted that the success of Chile's program would depend on an increase in the traditionally low level of domestic savings. On the bright side, it was encouraging to note from Mr. Nebbia's statement that, apart from the measures already adopted to control current government expenditures and to ensure payment of appropriate interest rates to stimulate savings, the authorities intended to implement an income tax reform to foster private savings and investment.

He would appreciate elaboration on the decision to maintain a uniform tariff level in Chile, Mr. Arias commented. Such a tariff spread the protective effect too widely, and he wondered whether Chile would not have been better advised to differentiate between those imports that had the greatest chance of being substituted and those for which Chile's potential comparative value was less. The uniform tariff was a fiscal device that might usefully have been replaced by a uniform excise tax. He also questioned the value of pricing goods and services sold by the public sector at levels in excess of opportunity costs, especially at a time when resources were needed to help finance investment. The approach taken was the same one that had been used during the postwar period by many industries in developed countries; but he saw no reason why resources to finance investment in a given industry should be preferentially obtained by a tax on consumers of that industry's product. Finally, he commended the Chilean authorities for their recent decision gradually to eliminate, according to a set schedule, the subsidies that were currently conducted through the Central Bank and to adopt an additional 8 percent devaluation, a step consistent with economic growth and with Chile's balance of payments objectives.

Mr. Pérez said that he supported Chile's requests. In relative terms, Chile was one of the most indebted countries in the Western Hemisphere. Its debt/GDP ratio was 96 percent, a figure far higher than that registered by other major borrowers, such as Brazil, Mexico, and Argentina. The debt represented more than four times annual exports, and the debt service payments in 1984 had amounted to a staggering 82 percent of exports; interest payments alone had represented nearly 50 percent of exports. What was more worrying, however, was the fact that those figures had been registered in a year that had followed an intensive and drastic adjustment. As shown in Table 2 of the staff report, real GDP in 1984 had been 10 percent lower than the level registered in 1981, notwithstanding higher than expected economic growth. Moreover, real wages and per capita consumption had fallen 20 percent in 1984, while imports had declined by 40 percent.

As mentioned in Mr. Nebbia's opening statement and in the staff report, Chile's adjustment efforts had been greatly complicated by the continuing deterioration in the country's terms of trade resulting from a very weak copper market, Mr. Pérez continued. The rise in interest rates in the early 1980s had also contributed to Chile's difficulties, and the recent downward movement in those rates was one of the few positive developments in Chile's external environment.

In his view, two structural characteristics of the Chilean economy--a low domestic savings rate and a dependence on copper exports--lay at the core of the country's difficulties, Mr. Pérez remarked. Chile needed a longer-term economic program aimed at substantially increasing the level of domestic savings, diversifying the export base, and providing some form of debt relief. The thrust of the proposed program was thus appropriate, and he welcomed the participation by both the Fund and the World Bank in Chile's adjustment effort. The policy mix contained in the Fund program was aimed mainly at increasing the level of domestic savings and maintaining the overall competitiveness of the economy, while the structural adjustment loan of the World Bank should provide the basis for a diversification of exports. The program to be supported by Fund resources contemplated the reduction of the savings-investment gap through the strengthening of the finances of the public sector; the reconstruction of the financial system; a more restrictive monetary policy, including higher real interest rates; and fiscal reform aimed at providing supply-side incentives to firms.

While those measures were a step in the right direction, a permanent increase in the overall level of savings in Chile could not be effected in the context of a stagnant economy, Mr. Pérez observed. An abrupt increase in public savings would inevitably crowd out private savings, while supply-side measures had not yet proved their effectiveness in strengthening savings in other countries where they had been applied. What was clear, however, was that savings were unlikely to improve when incomes were declining; hence, it was important for Chile--a country that had already undergone substantial adjustment--to provide in the "second phase" of the adjustment process an appropriate mix of further adjustment and financing. In that regard, he noted with concern that, for 1985--the first year of the extended arrangement--a further drop in real wages and consumption levels was being projected.

He was encouraged to note that an arrangement between Chile and the commercial banks had been agreed and that the Chilean authorities had successfully resisted the pressures levied upon them to guarantee the whole of the private debt, although a State Guarantee Option had been given for the debt of the financial system, Mr. Pérez commented. Since Chile was a country that had undergone a strong adjustment effort and had made its payments on time, he was deeply troubled that the arrangement had been concluded only after lengthy negotiations and considerable initial reluctance on the part of the commercial banks. Even after the preliminary restructuring arrangement, Chile's external debt situation would remain unduly severe. In that respect, he noted from Table 12 of Supplement 1 to EBS/85/122 that debt service as a proportion of exports would remain high throughout the program period, and interest rates would continue to represent a heavy burden on the economy in terms of GDP and export proceeds. In light of those figures, he would have thought that greater debt relief--perhaps in the form of a multiyear rescheduling arrangement--would have made a positive contribution to the success of the program.

Mr. Ismael considered that the Chilean authorities should be commended for the courageous actions they had taken under the recently concluded stand-by arrangement. Growth had resumed, following a period of severe recession and, in the face of severe pressures on the financial system and adverse external developments, most of the program targets had been achieved. At the same time, inflation, unemployment, and external debt remained areas of serious concern. Chile was a clear case of a country in which adjustment could not reasonably be expected within the span of one or two years, and adequate financial support must be ensured in the meantime. In that respect, he was satisfied with the staff's proposal to finance, through the extended Fund facility, a program that provided for a sustained reduction in the current account deficit, moderate economic growth, and a reduction in inflation; and he welcomed the fact that a structural adjustment loan from the World Bank would reinforce the objectives of the Fund program. Chile also appeared to satisfy the requirements set forth in the decision on compensatory financing of export fluctuations, and he could support the request for a purchase under that decision, especially since the shortfall was far larger than the remaining entitlement.

He agreed with others that the root causes of weakness in the Chilean economy were a very low savings rate and excessive reliance on a vulnerable copper market, problems that could be addressed through structural adjustment, Mr. Ismael remarked. Agricultural production in Chile had shown signs of improvement in 1984, and imports of food had been reduced. Measures to stimulate noncopper production and exports, particularly in more labor-intensive products, would be helpful. He agreed with the World Bank that the authorities should also develop the infrastructure needed for private investment in agriculture, fishing, and forestry. The reduction in real wages and salaries, especially by the Government, would continue to be helpful in supporting the trend of increasing employment.

The persistently low savings rate had created a large financing gap that, so far, had been met chiefly by foreign borrowing, which had culminated in the financial crisis of 1983, Mr. Ismael observed. The success of the authorities' adjustment effort required sustained implementation of policies to raise the savings performance, both to finance the investment necessary for economic growth and to reduce reliance on foreign savings. The reform of the income tax system should be implemented without delay. While positive real rates of interest might have helped to encourage some capital reflows, they had not yet had a discernible effect in encouraging private savings; a more important factor in the effort to encourage such savings was confidence in the financial system. In that respect, he wondered whether the projected increase in the national savings rate to 11.5 percent in 1987 from 2.9 percent in 1984 might be overoptimistic.

Chile's fiscal performance had been relatively prudent, Mr. Ismael considered. The slippage registered in 1984 was likely to be reduced in 1985, and the parastatals had a rather enviable record in that only the railways and the airline had suffered operating losses. In aggregate, the operating surplus of the public enterprises was likely to increase in 1985. He had no difficulty with the contingency plan of the authorities to provide for additional public expenditure in case private investment was weaker than expected; however, caution should be exercised to prevent premature or excessive disbursements.

The measures taken in recent years to improve monetary policy in the wake of the financial crisis had been unavoidable and expedient, Mr. Ismael noted. He supported the measures outlined in the program for limiting the operations of the Central Bank, reducing the scope of its subsidized programs, and enhancing the role of market forces in the determination of interest rates. In particular, he welcomed efforts to strengthen the financial system, so as to promote domestic savings and perhaps pave the way for a revival of direct foreign investment, which had fallen off substantially in 1984.

The deterioration in the external accounts in 1984 had been due mainly to unfavorable exogenous developments, Mr. Ismael said. While heartened by the improvement expected for 1985, he could not help wondering whether the projected 19 percent decline in imports was realistic and whether developments during the first half of the year had yet confirmed those projections. The authorities' policy with respect to the exchange rate appeared broadly appropriate, as did the external debt policy. He supported the intention to reduce reliance on private markets in favor of borrowing from official sources, including multilateral development institutions; and he agreed with Mr. Nebbia that it was crucial to the program that such financing was provided. Finally, he had found the sensitivity analysis in the medium-term scenario to be particularly useful, as it underscored the impact of the terms of trade and interest rate assumptions on the open Chilean economy. Developments would need to be monitored closely, and prompt and appropriate action must be taken to rectify any deviations that might arise during the course of the program. In conclusion, he supported the proposed decisions.

Mr. Joyce observed that the provision of supplementary information on Chile only three days before the meeting had given him some difficulty. His authorities had been prepared to support Chile's request for an extended arrangement based on the progress being made in addressing Chile's immediate economic problems as well as on the measures--announced in late June--aimed at stimulating exports. The support of his authorities had also been premised on the understanding that Chile had reached agreement in principle with the Bank Advisory Committee on a comprehensive financial package. Unfortunately, the latest information suggested that management had not yet received assurances from most of the creditors of their commitment to the financing package; and Executive Directors were being asked to make their decision on the extended arrangement conditional on the receipt within 30 days of firm assurances with respect to the required financing.

A glance at Supplement 1 to EBS/85/122 showed that the latest financial package proposed was somewhat different from the original and had required what were described as "technical revisions" to the earlier proposed quantitative criteria, Mr. Joyce remarked. He had not had the time to become fully familiar with all the details of those changes, but their main impact seemed to be to shift the schedule of disbursements under the agreements reached with the foreign creditors further into the future, thus slowing the progress of rebuilding the Central Bank's international reserves. As a result, the timetable originally envisaged for the program must be modified. He could accept the new dates proposed for the midyear review under the program and the shifting forward by one quarter of the originally proposed schedule of purchases; however, in accepting those changes and maintaining his authorities' support for the program as revised, he was relying heavily on the staff's assurances that the changes did not affect the adjustment effort envisaged in the original economic program.

Recent information on the first half of 1985 showed a number of favorable developments, Mr. Joyce continued. Credit policy had been somewhat tighter than projected, reductions in the interest rate subsidies announced in May and July were expected to lower the Central Bank's operational losses, and the deficit of the nonfinancial public sector had continued to shrink, despite some shortfalls in current revenue. On the negative side, the anticipated trade surplus had not been as large as hoped.

The policies proposed and the strategy outlined in the program for Chile, if aggressively pursued, should help to reverse the financial deterioration in the economy, Mr. Joyce said. However, continued strong control over domestic demand, supported by supply-side adjustments, would also be required to facilitate a significant shift in resources into the tradable sector and to provide for a greater mobilization of domestic financial resources. Such adjustment was essential if the debt burden was to be progressively eased within the context of an acceptable level of economic growth over the medium term. The Chilean authorities had struck an appropriate balance between demand restraint and efforts to promote structural adjustment. In particular, measures under the proposed extended arrangement were rightly aimed at correcting many of the policy problems observed during the previous Executive Board discussion on Chile.

Especially welcome were additional tariff reductions, reforms in the domestic financial market, and the commitment of the authorities to maintaining a flexible exchange rate policy. Given the heavy debt burden and the continued sensitivity of the Chilean economy to volatile external developments, the authorities would need to maintain a high degree of flexibility to ensure that the economic goals were met. A large part of the economic shortfall in 1984 had come about because the authorities had failed to react quickly enough to adverse developments in copper prices and interest rates. If those developments were to be repeated during the life of the new arrangement, it would be particularly important for the authorities to respond swiftly. Any deterioration in economic conditions would almost certainly have to be met through further adjustment measures rather than additional financing. In that respect, it would be a mistake to take the 1984 approach and attempt to meet increased financial requirements through contracting of short-term debt. In any event, reliance on debt with maturities of five years or less would have to be contained if the debt-servicing ratio was eventually to be brought to more manageable levels.

The fiscal plan under the proposed program was admittedly ambitious, although no alternative routes were open to the authorities, Mr. Joyce considered. If the debt burden was to be reduced and sufficient resources were to be made available to the private sector, the Government must finance more of its capital program from public savings while at the same time ensuring that interest rate policies were geared to encouraging a greater volume of private savings. The projected tax reform had an important role to play in that endeavor, although the primary goal of fiscal policy over the next few years must be to eliminate the deficit.

On the monetary side, Mr. Joyce welcomed the intention of the authorities to ease the debt burden of the private sector and improve the liquidity of the financial system. Unfortunately, the measures used in the past to realize that goal had resulted in a financial burden on the Central Bank that could no longer be sustained. Hence, he strongly supported the decision to limit the operations of the Central Bank and reduce the scope of its subsidized programs. The authorities were also to be commended for their determination to facilitate a reform of the financial system and to increase the role of market forces in determining interest rates. If pursued diligently, those measures would help to offset the reduced access to foreign savings. However, he shared some of the staff's concern about the financial costs of recapitalizing the domestic banks; while supporting the measure in principle, he was concerned that it should be implemented in a manner consistent with the overall adjustment effort.

The Chilean authorities must continue to facilitate a shift in resources to the external sector in order to promote a substantial expansion of exports in the coming years, Mr. Joyce commented. Achievement of that goal would, of course, be complicated by the outlook for copper prices. Over the years, Chile had successfully reduced its reliance on copper exports through diversification, and that process would need to continue if the medium-term export goals were to be met. Those goals could be achieved through the development strategy envisaged by the authorities, and he welcomed the assistance provided, or expected to be provided, by the World Bank in that area. An important component of the strategy, however, was the maintenance of competitive exchange rates, and therefore the most recent adjustment in the value of the peso was appropriate. He was prepared to agree for the time being to the maintenance of the current multiple currency practices and exchange restrictions, noting that those could be only temporary palliatives that should in due course be eliminated. In sum, he could support Chile's request for an extended arrangement with the Fund and for a purchase under the compensatory financing facility.

Mr. Rye remarked that the late delivery of the supplementary papers on Chile had given him some problems in clarifying his views. There had no doubt been good reasons for the delay, but he hoped that every effort would be made in future to avoid late delivery of such significant and complex papers.

He agreed with the staff appraisal and supported the proposed decisions, Mr. Rye said. The Chilean authorities should be commended for having brought the 1983-84 arrangement with the Fund to a successful conclusion, although it was disappointing that some of the December 1984 targets had not been observed. As noted by the staff, fiscal policy had eased somewhat during the final quarter of 1984, a development that had made more difficult the task of achieving the ceiling on the Central Bank's net domestic assets, especially given the indirect pressure already on that target from the September devaluation. Still, he was reassured by the information that the deficit had been sharply reduced in the first quarter of 1985.

While the December targets had been missed by relatively small margins, their nonobservance had initially given him some doubt about whether an extended arrangement was appropriate in the Chilean case, Mr. Rye said. However, the decisions by the authorities to phase out central bank foreign exchange swap operations and subsidies within 18 months and to accelerate the planned tariff reductions had eased his mind in that regard. Moreover, Chile had for the most part maintained a program of strong adjustment in the face of very difficult circumstances, including a sharp deterioration in its terms of trade and a virtual collapse of its financial system. Still, it had a long way to go to achieve balance of payments viability. The ratios of the current account deficit and of external debt service to exports--10.7 percent and 82 percent, respectively, in 1984--were still far from sustainable. Obviously, Chile would be relying on exceptional balance of payments financing for a number of years to come. The much-needed increase in private savings would be dependent on a restoration of confidence, particularly in the financial system, and that would take some time. The considerations he had mentioned all pointed to the appropriateness of an extended arrangement in the Chilean case; indeed, the adoption of such an arrangement might itself contribute to the development of confidence, given the commitment to medium-term adjustment that it would entail.

The potential of the Chilean economy was far greater than its recent performance would suggest, Mr. Rye considered. Certainly, prospects had been clouded by the fall in the price of copper, but that had been only one reason for the collapse of the economy in 1982. Two other developments--a prolonged appreciation of the real exchange rate and a substantial increase in real wages--had made it difficult for Chile to respond to the decline in the terms of trade that it had encountered in 1981 and 1982, although considerable progress had been made since that time in restoring external labor market competitiveness. The same two variables would be determining factors in the success or failure of the policies to be implemented in support of the proposed Fund arrangement. In that respect, he agreed with the staff that the authorities would need to "follow closely the behavior of the terms of trade, international inflation, and foreign interest rates and, as necessary, take timely exchange rate action to protect the balance of payments." For the time being, the real exchange rate was more competitive than it had been for some years; he understood that the latest adjustment had virtually eliminated the margin between official and parallel market exchange rates.

Chile's fiscal position seemed satisfactory, Mr. Rye commented. Indeed, by contrast with the situation in so many countries requesting Fund arrangements, a lack of fiscal discipline would not appear to have been a major problem in recent years in Chile. Moreover, the public enterprises as a whole had made a useful contribution to the budget. Of course, one could not overlook the sizable losses--equivalent to 4.6 percent of GDP in 1984--that the Central Bank had been incurring as a result of its foreign exchange swap operations and subsidies. As he understood it, those were not included in the public sector operating accounts shown in Table 5 of EBS/85/122. If they had been taken into account, the overall fiscal position would have appeared far less favorable. The announced measures to eliminate those losses were thus a positive step and should help materially to strengthen the public sector finances.

Despite the reported firmness in monetary conditions toward the end of 1984, the nonobservance of credit and reserves targets for December 1984 indicated that credit policy had not been tight enough, Mr. Rye observed. Against that background, he wondered whether the targets set for calendar year 1985 under the proposed arrangement might not be on the generous side. An increase in monetary liabilities of the private sector of 34.5 percent, even allowing for a 7-8 percent increase in the real demand for financial assets, seemed barely consistent with the effort to hold inflation to no more than 25 percent, especially given the possibility that 1985 had begun with an "overhang" of real money balances. Moreover, the stock of real financial assets had grown far faster than projected in the first quarter of 1985; and Chile's 12-month inflation rate to June 1985 had accelerated to more than 35 percent. Those developments only added to his doubts about whether monetary policy in Chile was sufficiently tight. The central importance of monetary policy was underlined by the continuing need for wage restraint, which he understood that the authorities intended to maintain in 1985. However, apart from holding civil service wage increases to the 14 percent increase granted in January, it seemed that the major tool of the authorities in their endeavor to restrain wages would be the maintenance of firm monetary conditions.

The state guarantee on private sector debt, which the staff had noted would cover "restructuring of private financial system debt due in the period 1985-87," was noteworthy, Mr. Rye remarked. The staff had expressed satisfaction that those arrangements were consistent with the statement in the economic policy memorandum that "the public sector is no longer in a position to extend a guarantee to...the rescheduling of principal payments by the private sector falling due in 1985 and in subsequent years." He was unclear whether those two points were consistent, and he would appreciate some further elaboration by the staff.

On the financing of the overall package, Mr. Rye observed that the World Bank had played an active role in securing commercial bank financing for Chile; specifically, the Bank had offered a guarantee on certain bank credits for a cofinanced roads project. He understood that those funds had, in effect, been "dressed up" for the purpose and might just as well have been classified as more general support. That, of course, was a matter for the Bank and not the Fund; and he presumed that the financing should be regarded as an example of Fund-Bank collaboration and the catalytic role of the two institutions. However, it gave rise to the more general question about the circumstances in which it was appropriate for the Fund or the Bank to take the lead catalytic role. He would welcome further comment from the staff or the Chairman on that matter.

Mr. Clark observed that Chile had for the most part kept closely to the targets of the previous stand-by arrangement; GDP growth had resumed and employment had increased. While some slippages had occurred in fiscal and external policy that appeared to have exacerbated the effects on the current account of the worsening terms of trade, the authorities on a number of occasions had shown themselves ready to take further measures--such as the devaluations of September and December 1984. However, while their determination to adjust was encouraging, it was disappointing to observe that, despite substantial short-term capital inflows, the performance targets at end-December for net international reserves and net domestic assets had been missed by a fair margin. Unfortunately, Chile was yet another case of a country that had missed targets at the end of an arrangement when no drawings were dependent upon their achievement.

The objectives of the proposed program were ambitious, but the size of Chile's external debt demanded their achievement if a viable external position was to be restored by the end of the decade, Mr. Clark continued. Obviously, much would depend on developments in copper prices and interest rates, as well as on the performance of the U.S. economy, whose share of Chile's export markets had more than doubled from 12 percent in 1980 to 26 percent in 1984. He agreed with the staff that, in the circumstances, the authorities would have to be prepared to take additional measures as warranted.

Among the prerequisites for an extended arrangement were a demonstrated commitment--and capacity--by the authorities to implement the necessary measures and a degree of stability in the policy environment that made medium-term planning realistic, Mr. Clark remarked. His authorities believed that Chile met those criteria, and they could support the proposed program. Their only doubts concerned uncertainties in the overall economic environment--particularly regarding copper prices--that could lead to sudden and serious pressure on the program.

Remarking on six specific aspects of economic policy in Chile, Mr. Clark first welcomed the substantial increase in public savings projected for 1985 as one important element in increasing national savings overall and reducing the need for external finance. As the staff's helpful medium-term flow of funds projections showed--an exercise that should be extended to other countries--a large increase in private savings would also be necessary; hence, he approved of the proposed tax reform. Second, the recent earthquake had been a serious blow to the economy, and he understood that the latest official estimates were for damage of about US$1.8 billion rather than the US$0.5 billion mentioned in the staff paper. He would be interested in hearing from the staff some elaboration on the possible implications of that damage for fiscal policy.

Third, Mr. Clark supported the authorities' efforts to strengthen the private financial system, particularly the proposals for a new law on banking supervision. The extensive support operations by the Central Bank had proved to be costly and had adversely affected the operation of monetary policy. In that respect, he welcomed the authorities' intention to eliminate the exchange rate subsidy on debt repayments over the period of the program together with further reductions in the interest rate subsidy on foreign currency swaps. Fourth, he agreed with the emphasis on export diversification, which was clearly essential if the balance of payments situation was to become viable in the longer run. Fifth, it was disappointing that the Chilean authorities still maintained the various multiple currency practices and exchange restrictions that had originally been scheduled for elimination by end-1983. He hoped that the authorities would act quickly to ensure that all those restrictions were removed during the period of the extended arrangement. Finally, the medium-term projections made clear that substantial capital inflows through rescheduling or other means would be needed for some time to come. A good portion of those would be needed for servicing of what had originally been private sector debt taken over by the authorities in the context of the 1983 commercial bank package. Noting the terms of the proposed agreement with the commercial banks, he urged the authorities to be cautious in taking on further guarantees, even with the compensation of a fee on the terms noted in Supplement 1 to EBS/85/122.

Like Mr. Joyce and Mr. Rye, he found that his reaction to the Chilean requests had been complicated by the late circulation of important supplementary information on Chile, including a change in the nature of the decision, Mr. Clark commented. Nonetheless, he had reached the conclusion that the Chilean authorities had demonstrated considerable commitment to adjustment in the face of difficult external circumstances over the past two years. He therefore welcomed the proposed extended arrangement and the request for a purchase under the compensatory financing facility.

Mr. Grosche remarked that, if the role of adverse external factors were taken into account, the Chilean economy must be judged to have performed well under the recently expired stand-by arrangement. Nevertheless, the deterioration in the current account during 1984 had also been due to overly growth-oriented and expansionary policies; and the lack of steadiness and constancy in the general conduct of economic policies in Chile was regrettable. In the circumstances, he welcomed the authorities' intention to pursue further adjustment in the context of an extended arrangement, which should help to put the adjustment process on a much broader footing and allow for greater continuity in the implementation of policies. He fully supported the program, particularly its basically outward-oriented adjustment and stabilization strategy. If growth prospects for exports materialized, if all the measures provided for under the program were strictly implemented, and if the international financial community stood ready to engage in a wide-ranging rescheduling exercise, then the program would indeed represent an important step toward the restoration of viable external accounts while maintaining positive growth rates for output and income.

He welcomed the indication that a financial package for 1985-86 was being concluded, and he hoped that written assurances would be received within the expected 30-day period confirming the banks' willingness to go ahead with their share of the package in order that the proposed decisions that Executive Directors were being asked to adopt in principle could be made effective as soon as possible, Mr. Grosche said. Since the banks were also prepared to engage in a multiyear rescheduling agreement, he wondered whether the amended medium-term projections on page 22 of Supplement 1 to EBS/85/122 already reflected the possible results of such an arrangement.

The Chilean program was comprehensive and offered a convincing blend of global and structural policies, Mr. Grosche considered. As already indicated, the strategy to seek growth rates that were higher for exports than for GNP seemed to be the only promising adjustment path. Of course, the export-led growth strategy was not without risks, given the high vulnerability of export prices. Those risks had been demonstrated in 1984 and again during the first five months of 1985 when the trade surplus had been smaller than expected. The medium-term scenarios made it clear that the success of the Chilean strategy also depended upon a sustained growth performance in the industrial countries and on a further moderation of international interest rates. He wondered whether any contingency plans existed to counter the possible emergence of adverse external conditions. Finally, while he could support Chile's request for a purchase under the compensatory financing facility, given that all relevant criteria had been met, he noted that Chile was yet another case in which the shortfall was being arrived at through a positive assessment of postshortfall years. Such an approach might have been more troubling if the proposed purchase--equivalent to less than 30 percent of the estimated shortfall--had been greater.

Mr. Lundstrom observed that the proposed extended arrangement program was based on assumptions that seemed optimistic, particularly in the areas of domestic savings and export developments. Even small downside deviations from those assumptions could jeopardize the medimu-term targets for investment and growth.

Earlier failures of adjustment policies in Chile, especially in the late 1970s and early 1980s, had been due in part to factors beyond the control of the authorities as well as to flawed economic policies, Mr. Lundstrom remarked. Against that background, it was essential that future developments should be closely monitored, and the authorities should be ready to take corrective action rapidly if warranted. Finally, while his authorities had some doubts about the proposed program, they were of the opinion that a comprehensive Fund-supported adjustment program was a prerequisite for debt consolidation and they could therefore go along with the proposed decisions.

Mr. Fujino observed that a review of Chile's performance under the previous stand-by arrangement demonstrated that the authorities had pursued adjustment measures with determination. The reduction in the balance of payments deficit had been the focal point of the adjustment program, but the actual trade surplus had been considerably lower than programmed. The deterioration had mainly been due to adverse external developments, particularly a decline in copper prices and an increase in international interest rates. Although the result was regrettable, it had led the authorities to renew their efforts to carry out the necessary adjustments.

The deterioration in Chile's external position, together with its sizable foreign debt, had again posed a serious threat to sustained growth in the Chilean economy, Mr. Fujino continued. To carry out the needed adjustment, the authorities had requested an extended arrangement with the Fund and a structural adjustment loan from the World Bank. He agreed with the staff that the objectives set out in the economic program, while ambitious, could be achieved under the policies and external circumstances envisaged in the program. In spite of the smaller than programmed trade surplus, the balance of payments projection remained as originally envisaged. However, as indicated by the alternative scenarios, lower than programmed copper prices or higher than programmed foreign interest rates might eventually require additional adjustment measures.

While he could endorse the thrust of the staff appraisal and supported the proposed decisions, including the request for an extended arrangement and a purchase under the compensatory financing facility, he believed that an outright approval of the extended arrangement would have been more appropriate in a case like that of Chile where assurances on the financial package had already been received from the Bank Advisory Committee, Mr. Fujino said. The approach of "approval in principle" should be used sparingly. On a related matter, he joined previous speakers in expressing regret at the late distribution of important and substantial supplementary information on Chile.

The level of the exchange rate in Chile seemed adequate, Mr. Fujino noted. However, it should be recalled that, under the current daily adjustment mechanism for the rate, the peso had tended to appreciate in the past because of the continuous rise of the U.S. dollar and because of the somewhat arbitrary estimation of price developments abroad. Exchange rate developments in Chile should be monitored closely and, if necessary, timely exchange rate action should be taken. Moreover, the authorities' concern about the impact of the devaluation on domestic prices could be more effectively addressed by a reduction in tariff rates. In that respect, the staff might have been correct in observing that the success of the economic program would depend to a great extent on the implementation of a flexible exchange rate policy. However, that statement should not be understood to mean that an exchange rate policy could solve every problem. Prudent demand management policies remained central to the adjustment process, and exchange rate policy should be accompanied by structural adjustments and various efforts toward expansion of the tradable goods sector.

The central bank subsidy was another major area of concern, Mr. Fujino commented. Although monetary policy for 1985 was designed to reduce that subsidy, it was expected that the Central Bank would incur operational losses amounting to 3 percent of GDP. Hence, he welcomed the authorities' intention to eliminate the interest on swap operations and the premium on foreign currency deposits in 18 months.

The domestic financial system must be strengthened in order to pave the way for an expansion of private savings, Mr. Fujino remarked. In that regard he had taken note of some prudent elements in the recapitalization scheme, such as the maintenance of the real value of the substandard loan portfolio that had been purchased by the Central Bank and the reduction of the monetary impact of the cash purchase through the repayment by banks of emergency loans from the Central Bank. However, it was unclear whether such extensive involvement by the Central Bank would be conducive to the maintenance of discipline and soundness in Chile's financial system. Also, since banks must use their future operational surpluses to replace the portfolio, he wondered whether the repurchase of the portfolio would not become a heavy burden for the future operations of those institutions.

Mr. Polak noted that unlike Brazil and Mexico, Chile was not yet able to eliminate its dependence on new bank lending, an essential step toward normalization of creditor-debtor relations. The proximate causes of Chile's less satisfying progress toward that end were the following: an external debt amounting to 100 percent of GDP; and an export structure--and an unfavorable trend in copper prices--that prevented a rapid expansion of export earnings. As a result of those factors, even the 50 percent cut in imports effected by the authorities had not been sufficient to create the trade surplus of almost 10 percent of GDP that would be needed if Chile were to do without new credit. Indeed, if no new money were to be provided, imports would have to be cut still further. That might create even more doubts about Chile's ability to achieve a sustainable position than had been raised by the current approach under which Chile had two more years to expand its export base and prepare for the undoubtedly severe transition to a normalization of relations with its creditors. The authorities could not afford to consider the course of action as a holding operation, waiting for a turn for the better in Chile's terms of trade; rather, they must take all measures possible to improve exports.

The latest projections in the World Bank's assessment of Chile's investment plan indicated that emphasis remained heavily on primary commodity exports, in spite of the fact that Chile had a substantial and not uncompetitive manufacturing industry, Mr. Polak noted. Even if it were true that Chile's comparative advantage was still in producing primary commodities--and that might no longer be the case in a period of very low primary commodity prices--diversification might limit the economy's vulnerability to a shift in terms of trade. In passing, he pointed out that very little description of the role of the World Bank in Chile appeared in the staff report, despite the Bank's obviously large involvement.

A flexible exchange rate policy must be maintained if the current account targets were to be met, Mr. Polak considered. It was worrying that the trade account in 1985 would not improve by as much as projected. However, he welcomed the reduction in the interest bill, part of which was due to an improvement in the terms under existing agreements.

Strict adherence to the proposed fiscal and monetary policies was also essential, Mr. Polak continued. It was not clear why the huge operational losses experienced by the Central Bank in 1983 and 1984 had not been integrated into the fiscal accounts as presented in the staff papers. Nonetheless, he welcomed the tough measures that had recently been taken to reduce the quasi-fiscal deficit. The gradual elimination of the preferential exchange rate for debt service would provide a powerful incentive to all companies with foreign debt to expand foreign exchange earnings; however, he remained concerned about the fact that private capital flows continued to be substantially subsidized by the Central Bank.

He had not found in the medium-term balance of payments projections any specifications of the amounts due to the Fund in the coming period, Mr. Polak said. Since the rationale of the medium-term scenarios was, inter alia, to assess the capacity of a member to repurchase on time, it seemed odd that no mention of those amounts had been made. In conclusion, he was willing to approve the proposed decisions, although he doubted whether a three-year extended arrangement was the optimal choice in the case of Chile. His preference would have been for a two-year arrangement, first, because the policy program was basically a two-year program, and second, because the uncertainties regarding developments in the price of copper made it difficult to commit Chile and the Fund to each other in a three-year arrangement.

Mr. Zecchini remarked that the performance of the Chilean economy in 1984 had not been satisfactory in a number of areas, particularly those relevant to a country that was hard pressed to reduce its excessive external debt. The deficit on the current account had almost doubled that in 1983 and had largely exceeded the programmed level. The deterioration could not be attributed exclusively or even principally to developments beyond the control of the authorities; on the contrary, a main cause of the deterioration was the pronounced weakening of the initially tight economic policy stance aimed at constraining domestic demand expansion, curbing the public sector deficit, and slowing the rate of credit expansion. On those three fronts in particular, performance had been disappointing. Domestic demand had been allowed to outpace by nearly 5 percentage points the growth in GDP and, implicitly, the capacity of domestic supply to meet fast-rising demand. That outcome was reflected in a larger than programmed increase in imports of goods and services, which had occurred in a period when the projected increase in exports had failed to materialize. Also, no significant cut had been made in the ratio of general government expenditure to GDP, with the result that the overall deficit had been in excess of the programmed level. Moreover, the large financing needs of the public sector had prevented the tightening of monetary policy to the extent necessary fully to comply with the 1984 financial performance criteria. At the end of 1984, three of the five criteria had not been fulfilled; and, among the failures, there had been a significant deviation from the limit on the net domestic credit of the Central Bank.

For the first quarter of 1985, the economic trends in Chile continued to be a matter of concern, Mr. Zecchini went on. The balance in the current external accounts still showed significant deviations from the expected path, with improvements falling short of the staff's projections. Furthermore, following a limited decline in 1984, inflation was back on a rapidly accelerating course, as shown in the 12-month rise in the consumer price index from 27 percent to 35 percent between January and June 1985. As a consequence of that rise, and notwithstanding the depreciation of the peso, a steep appreciation of the real effective exchange rate had emerged and would lead, in all likelihood, to an erosion of the external competitiveness of noncopper exports. The appreciation raised many doubts about the Government's stated policy of depreciating the peso on the basis of inflation differentials as an effective means of preserving competitiveness.

The recent economic trends and policies he had mentioned were important elements in the assessment of the probability of a successful implementation of the requested extended arrangement, Mr. Zecchini commented. The program had essentially the same objectives as its predecessor, namely, to reduce significantly the deficit in the current external account against a background of moderate economic growth and declining inflation. The main difference with respect to the 1983 program lay not so much in the longer time frame as in the much larger size of the adjustment effort that was envisaged to curtail the external deficit to 1.8 percent of GDP in 1988-90. The implication was for a drastic cut in the excess of domestic investment over national savings from the 1984 level of 10.7 percent of GDP. A look from another perspective at the macroeconomic identity between the current account deficit and the savings-investment imbalance suggested that the nation's propensity to save would rise from 2.9 percent to 15.2 percent of GDP in a period of less than four years; if it did not, the adjustment of the external deficit would have to be achieved by reducing investment below the programmed level, which would make it very difficult for the country to reach the projected export level.

Given the strength of the envisaged adjustment, it was only reasonable to ask about the likelihood of the program's success, Mr. Zecchini said. Over the past ten years, the savings ratio had never risen as high as 10 percent and had never experienced the quantum leaps that the program was envisaging from one year to the next on a continuous basis until 1988. Of course, it could not be denied that such shifts could take place if they were brought about by radical policy changes or extremely favorable external developments. In the circumstances, it was appropriate to look at some of the factors that could lead to the programmed reduction of Chile's reliance on external savings. Those factors could be placed in three categories: public sector savings; private sector savings; and the performance of exports against imports of goods and services.

He had already noted the difficulties that the authorities had been facing in their effort to cut current expenditures and to reduce the deficit of the nonfinancial public sector to the extent programmed for 1984, Mr. Zecchini continued. In spite of recent reductions in expenditures for wages, goods, and services, it was difficult to believe that the Government could proceed much further with expenditure cuts during the next three years. Moreover, in its policy memorandum, the Government had maintained sufficient room for introducing additional expenditures under the contingency plan. If the focus were broadened to include the financial public sector, new outlays might emerge as a result of the policies aimed at higher interest rates and reduced financing of the public deficit by the Central Bank. At the same time, the Government was considering some income tax cuts to enhance private savings, measures that were likely to lead to larger deficits if they were implemented before major expenditure reductions were completed.

On the potential for private savings, Mr. Zecchini said that it was questionable whether the household propensity to save would increase as required in the face of the planned extensive reductions of wages and public transfers. Also, the private business sector did not appear in the best position to raise its savings at a time of increasing interest rates and lower subsidies.

The attainment of the objective of an increased trade surplus was also questionable, Mr. Zecchini commented. Export performance was highly sensitive to trends in the world copper market and depended crucially on the effectiveness of the exchange rate policy in preserving competitiveness. On both those grounds, many uncertainties remained. For example, the forecast of a rising trend for world copper prices did not seem to be in line with the trend observed in the past two years. Moreover, there appeared to be some inconsistency between the projection for an improvement in the terms of trade and the Government's commitment to a specific rule for depreciating the peso. It was also difficult to admit that imports could be stabilized in terms of GDP over the next three years while exports rose in the same relative terms, since such a development would imply a drastic and unrealistic lowering of the import content in projected exports.

On the monetary side, the possibility of a substantial deceleration in the growth net domestic assets of the Central Bank hinged upon the reduction of all financial programs involving subsidies to the private sector and losses for the Central Bank, Mr. Zecchini said. However, according to the staff paper, those programs and consequent losses "are likely to remain sizable...because of past contractual commitments." In sum, there existed a legitimate basis for serious doubts about the ability of the Chilean authorities to apply the degree of austerity that was called for by the program.

The projections used to support Chile's request for a purchase under the compensatory financing facility seemed optimistic and based on somewhat questionable assumptions, Mr. Zecchini remarked. Copper markets had been soft over the past four years, and there were no clear signs of a strengthening trend, as the staff had assumed. Indeed, a case could be made for a downward medium-term trend. Furthermore, the staff had stated that while copper exports for 1985 were expected to be in line with program estimates, noncopper exports would be some $200 million below original projections. Exports for 1986 were currently also expected to be $200 million below the originally programmed level. Those shortfalls had only a marginal influence on the revised shortfall for the compensatory financing facility, which had to be changed from an original estimate of SDR 241 million to SDR 236 million. While the figures for the extended arrangement were related to calendar years, the new figures for the compensatory financing facility were for a March-to-March year. Nevertheless, the difference between the two estimates of exports was far too large to give rise to only a minor revision in the shortfall. Besides, only two months after the circulation of EBS/85/124, it had become clear that the estimates for exports for 1985 had been too optimistic.

In conclusion, Mr. Zecchini observed that his Italian authorities had no confidence in Chile's ability to achieve the ambitious objectives of the rigorous program; consequently, they could not support the request for an extended arrangement. Similarly, they did not believe that sufficient grounds existed for a purchase under the compensatory financing facility.

Mr. Suraisry said that he could support Chile's request for an extended arrangement and for a purchase under the compensatory financing facility, and he joined those who had expressed concern about the late circulation of the supplementary papers.

The Chilean economy had undergone substantial adjustment in the context of its stand-by arrangement with the Fund, Mr. Suraisry continued. Adverse external developments in late 1984 had, however, placed the economy under strain and demanded a renewed adjustment effort. The proposed program focused on the structural adjustment necessary to ensure a continued growth in output, reduction in inflation, and achievement of a sustainable external position. The attainment of those objectives depended upon the successful pursuit of exchange rate and demand management policies, as well as on a firm commitment to enhancing the supply side of the economy. The authorities should be commended for implementing a flexible exchange rate policy, which should help to foster the development of the tradable goods sector and bolster demand management. The promotion of exports and import substitutes was especially important in light of Chile's heavy external debt burden. He was thus pleased to note that the authorities intended to continue managing the exchange rate in a flexible manner and controlling the external debt situation. Efforts to unify the exchange markets should also be continued. Further, he welcomed the recent moves to liberalize the trade system and, in that context, hoped that Chile's trading partners would relax trade restrictions on Chilean exports.

Chile's external debt burden underscored the need for the authorities to manage demand cautiously and to rely more on domestic resources to maintain the rate of growth, Mr. Suraisry commented. Domestic savings in Chile had been low for some time, and the authorities had relied heavily on foreign savings to finance their economic development. As a consequence, Chile had become one of the most heavily indebted countries in the world. With limited access to further foreign resources, Chile had no choice but to rely more on domestic savings and to improve its domestic production capacity. It was thus encouraging that public finances were to be strengthened in 1985 with a broadening of tax coverage and restraints on wages, transfers, and subsidies. He welcomed the pricing policies to be pursued by the public enterprise sector and the forthcoming tax reform so important to the enhancement of domestic savings and investment. Also welcome was the World Bank's involvement in the effort to reduce structural weaknesses in production.

The recent moves to strengthen the financial system should help the domestic resource mobilization effort, Mr. Suraisry remarked. The authorities were recapitalizing the financial system, introducing deposit insurance, and reforming financial legislation; over the medium term, those moves should help to re-establish a sound financial system. The proposed measures to reduce the pace of expansion of central bank credit were also necessary. In recent years, central bank debt refinancing and other subsidized programs had expanded at a very rapid pace and had resulted in significant operational losses.

Finally, Mr. Suraisry noted that Chile continued to face serious structural problems. The alternative scenarios outlined in the staff paper gave the authorities an indication of the relevant trade-offs necessary to achieve the program targets. Full implementation of the outlined policies was needed, as there was little room for slippage against the background of Chile's external debt burden. The proposed program, together with the recent reduction in interest rates, provided a good opportunity for Chile to correct its imbalances, and the authorities should not let that opportunity pass.

Mr. Dallara recalled that during the December 1984 review of the Chilean adjustment effort (EBM/84/178), it had become evident that substantial slippages--deriving from both endogenous and exogenous factors--had been occurring during the latter part of the two-year stand-by arrangement. They included a serious shortfall in the savings effort, a somewhat higher than targeted inflation rate, a substantial overshooting of the current account deficit of the balance of payments, an excess in the fiscal deficit, and a faster than targeted pace of credit expansion. The authorities had acted fairly promptly in an effort to arrest deteriorating circumstances, although some of the policy responses had been of the stop-gap variety rather than more comprehensive actions to deal with fundamental underlying problems. Evidently, the Chilean authorities had reached the view that an effort to address the basic problems was called for, and they were currently seeking the support of the Fund in that effort.

At the heart of Chile's problems was the long-standing inadequacy of domestic savings and the corresponding reliance by the authorities on foreign savings, Mr. Dallara continued. The result had been a large and rapid buildup of foreign debt to the extent that, by end-1984, the ratio of total foreign debt to GDP had reached 96 percent, which contrasted with a ratio of only 40 percent as recently as 1980. Between 1981 and 1984, the ratio of gross domestic investment to GDP had fallen from nearly 23 percent to less than 14 percent; and, over the same period, private savings had averaged only 3 percent of GDP. Unless something was done about the savings effort, Chile would continue to face the choice of either inadequate growth based on a low level of domestic savings or a more acceptable growth rate at the expense of a sustainable payments position.

Further exploration of the savings-investment pattern in Chile uncovered a number of puzzling elements, Mr. Dallara continued. In the past few years, for example, real wages had fallen, which suggested a strengthening of business profits and the potential for reinvestment of earnings. The expansion of domestic credit to the private sector had been more than ample, and real interest rates had generally been high, presumably creating an incentive for savers but, perhaps at the same time, impeding investment demand. Staff comment on those structural issues would be welcome.

In the public sector, the ratio of public savings to GDP had been negative or had approached zero in each of the past three years, Mr. Dallara observed. Such a ratio was clearly inconsistent with an average public investment ratio over the past four years of 5.4 percent of GDP. The overall deficits of the General Government and of the entire public sector had also risen steadily, from a small surplus in 1981 to sizable deficits at present. In addition, deficits of the Central Bank arising from special assistance to the private sector had amounted to 2.9 percent and 4.6 percent of GDP in the past two years and were expected to fall between those two numbers in 1985. The authorities were aiming at a substantial cut in the public sector deficit ratio in 1985 to 3 percent of GDP, although that projection could rise if activation of the contingency fund proved justified.

On the monetary and banking front, Mr. Dallara remarked that the exercise of monetary policy in Chile had been hindered considerably by the need to provide emergency assistance to the banking system. Although that need had been encountered elsewhere in recent years, the Chilean requirement appeared to be among the most serious and complicated. The banking crisis had involved the Central Bank in operations that did not seem appropriate over the long run. He welcomed the termination of those operations as the banking crisis ebbed.

It was evident that the steady worsening in the terms of trade had imposed a limit on the rapidity with which balance of payments adjustment had been effected, Mr. Dallara said. The terms of trade index in 1985 was expected to be more than 20 percent below its 1980 level, a factor that, to some extent, accounted for the high ratio of the current account deficit to GDP, which exceeded the 1984 target by a considerable margin. Indeed, lower than expected copper exports alone had accounted for nearly one third of the overall overshooting of the current account deficit target. However, higher than expected imports and less than anticipated noncopper exports together had been even more important factors. Import growth, in turn, had reflected an easing in monetary and fiscal policy during part of 1984. While the current account ratio was to be cut in 1985, the most recent data were not altogether encouraging.

A review of the performance of the Chilean economy in recent years showed some volatility in certain areas, Mr. Dallara observed. The efforts at adjustment, while impressive in some respects, had not been entirely consistent; and the authorities had clearly experienced some difficulty in responding to developments that had often been unexpected and due to circumstances largely beyond their control. If Chile was to establish a more stable economic and financial environment and reconcile the difficult objectives of medium-term growth and a sustainable balance of payments position, the authorities would need to implement appropriate fiscal and exchange rate policies while at the same time effecting fundamental reforms in the economy. Some of those reforms had been, or were being, effected through the adoption of recent measures, while others would need to be accomplished over the course of the three-year program, the basic objectives of which seemed to be appropriate.

Among the structural changes of particular importance was the full implementation of tax reform by 1986 aimed at improving public savings and providing incentives for private savings and investment, Mr. Dallara commented. The authorities should be encouraged to implement the tax reform fully and on schedule and should maintain the reform effort--over the medium term, if necessary--to ensure that appropriate incentives were provided to help deal with the critical savings-investment imbalance. The expected cut in both personal and corporate income tax rates, tax benefits for reinvested earnings, and a tax reduction for personal savings were all steps in the right direction.

Important planned reforms on the monetary side included limitations on the scope of central bank involvement in financial markets, a reduction in the banks' quasi-fiscal deficit, more market-oriented interest rates, a strengthening of the financial position of the banking system, increased supervisory power for the Superintendency of Banks and Financial Institutions and, eventually, the introduction of deposit insurance, Mr. Dallara noted. Those reforms should be helpful to the authorities in dealing with the problems that had beset the financial sector in recent years; but they should also have positive effects on the medium-term balance of payments outlook, which needed to be reinforced through a flexible exchange rate policy, lower import duties, flexible interest rates, and the liberalization of some trade and payments restrictions. He welcomed the recent uniform tariff cut--well beyond what had originally been envisaged--which by itself could have a positive effect on the balance of payments, particularly nontraditional exports. He would be interested in any information on planned future cuts in the tariff. He supported the temporary approval of two multiple currency practices and two exchange restrictions, since the authorities were already committed to taking specific measures to reduce or eliminate those practices and restrictions during the program period.

The various reforms he had mentioned provided a sound basis for the needed structural adjustment in Chile's economy, Mr. Dallara observed. However, some serious economic problems could remain beyond 1987, which suggested the need to reinforce the adjustment effort in the context of the program. Moreover, at the end of 1989, Chile would have benefited from seven program years of Fund assistance since 1974, and its obligations to the Fund would be significant. In the circumstances, it must be stressed that the program provided an important context for adjustment, including some fundamental changes in the Chilean economy, but that the room for slippage in the adjustment effort was marginal, given the difficult outlook that would inevitably exist at the end of the adjustment period, even with successful program implementation.

The fact that the adjustment program was being supplemented and reinforced by a structural adjustment loan from the World Bank was welcome, Mr. Dallara said. That loan should aid the medium-term adjustment effort to improve export incentives and provide institutional support for noncopper exports. However, given the structural focus of Chile's adjustment effort, he was disappointed that more information on the structural adjustment loan had not been provided. He hoped that that deficiency could be corrected on the occasion of the upcoming review.

In sum, Mr. Dallara remarked that he could support the proposed extended arrangement, which he hoped would provide the authorities with an opportunity to redress some of the fundamental problems besetting the Chilean economy, particularly the savings-investment imbalance. He had the impression that Chile could not continue to weather the substantial swings in its economic variables that had occurred over the past few years and that, if the underlying imbalances were not redressed, Chile would have to live with the prospect of a lower growth rate in the context of its payments position. He could also go along with the proposed "approval in principle" approach, although he did so with some hesitation, since he believed like other Directors that the approach should be used on a limited basis. However, when the Executive Board had discussed the issue in October 1984 (EBM/84/155), it had left open the possibility of resorting to the approach in a few cases. In his concluding remarks at the end of that discussion, the Chairman had stated that where "substantial uncertainties remain with regard to the financing of a program, and if management believed that in exceptional circumstances approval in principle would assist the member in reaching agreement with its creditors, the procedure would be used."

It was his understanding that official creditors in the Chilean case had sought prior assurances that an approval in principle by the Board could facilitate the official rescheduling, Mr. Dallara stated. His hesitation in approving the approach was related partly to the fact that the critical mass of new money from commercial banks had not yet been assured and that considerable difficulties had been experienced with regard to securing the needed financing for Chile. In that respect, the Board was perhaps taking some risk in adopting the proposed approach, although he recognized that written assurances from the banks would be sought during the 30-day period that had been provided for. Taking all considerations into account, he believed that the "approval in principle" approach was the appropriate one in the Chilean case.

On the request for a purchase under the compensatory financing facility, Mr. Dallara observed that Chile clearly met the tests of balance of payments need and cooperation with the Fund. However, the question of whether the shortfall was due to circumstances largely beyond the control of the member and whether it was temporary raised a number of concerns relating both to Chile's specific request and to more general considerations regarding the operation and general perception of the compensatory financing facility itself. First, he was concerned that, in some cases, member countries misjudged basic commodity trends and pursued production objectives that could be inconsistent with those trends. That action raised the fundamental question of whether, in a particular case, a shortfall was largely beyond the control of the member, or whether the shortfall was in some sense associated with production decisions that might not be supportive of world economic stability. He was also concerned that, in some cases, the staff might not fully take into account in its analysis important secular shifts that might be under way in certain commodity markets. That concern was clearly a relevant one in the case of the copper industry; and in such circumstances, it would be appropriate to explore the secular shifts in more detail.

More generally, Mr. Dallara continued, he was concerned about the formulation of production and investment policies for certain commodity producing sectors. While understandable in the context of efforts to improve export earnings in the short term and to achieve higher employment levels and job security, those policies might nevertheless not be entirely sound from a longer-term point of view, either for the country or for the world economy. Clearly, Chile was one of the world's most efficient and important copper producers; nevertheless, the continued expansion of production capacity--an expansion that did not in his view bear a close relationship to either current or prospective world demand--was a matter of serious concern. Copper production and capacity globally had increased substantially faster than the world's ability to absorb new supplies in recent years. As a result, stocks had increased, prices had fallen, and, in the face of no lasting increase in global demand, producers' revenues had often fallen as well.

He understood that during the past few years the Chilean Government had developed budget estimates based on estimated copper prices that had turned out to be in the range of 5-15 percent higher per pound than actual prices, Mr. Dallara said. While recognizing the difficulties of making such estimates, he was concerned that the approach might well compel the copper sector to maximize output, despite strong evidence that such an approach could have an unfavorable impact on the world market. In 1982, for example, when private producers had been forced to reduce production in the face of a global recession, Chile had actually expanded copper production and exports by about 16 percent, an action that had helped to swell world copper inventories to 1.5 million tons and had contributed to a protracted period of sharply depressed prices. The data provided by the staff made it clear that, in a narrow technical sense, in spite of its importance in world copper production, Chile's actions had had, and could have, only a limited short-run--and an even more limited long-run--effect on global copper prices. In accepting that point, he shared the view of the staff that the shortfall in the Chilean case was largely due to circumstances beyond the authorities' control.

The temporariness of the shortfall also raised some doubts, Mr. Dallara noted. The compensatory financing facility could indirectly be used, in effect, to finance shortfalls arising from longer-term structural developments in commodity markets. Those might not have been fully taken into account in the staff's analysis. For example, in the 1983 staff analysis of Chile's request for a purchase under the compensatory financing facility, a total shortfall of SDR 295 million had been estimated on the basis of a projected substantial copper market recovery in 1983 and 1984, the two postshortfall years. Actual data for those years showed, however, that the shortfall in copper had been less than SDR 115 million. It was not unreasonable to conclude that, in a sense, compensatory financing might encourage commodity producers to move ahead with production and investment plans that might not be wholly realistic and that could, unfortunately, foster a demand for compensatory financing and discourage the reallocation of scarce resources to sectors that offered better potential. He was not saying that the shortfall in the Chilean case was not a temporary one; but he hoped that the staff would, to the extent feasible, attempt to define and take into account the secular trends he had mentioned. At the same time, it was to be hoped generally that producers of commodities facing possibly declining secular trends would take those trends into account in their own decisions. In conclusion, he could go along with Chile's request for a purchase under the compensatory financing facility, especially since there existed a significant noncopper shortfall that exceeded the amount of the purchase and Chile had obviously established, and was continuing to establish, a record of cooperation with the Fund. However, in supporting the requested purchase, he was not in any way condoning or endorsing production or other investment decisions concerning the copper sector in Chile.

Mr. Jayawardena stated that his chair could support the requests for an extended arrangement and for a purchase under the compensatory financing facility. The extended arrangement was most appropriate in the Chilean case, because Chile's problems were structural in nature. In that respect, he was tempted to compare Chile with another copper exporting country, Zambia, that was even more dependent than Chile on a single product. Because Chile had a more diversified economy than that of Zambia, and had a higher per capita income, its problems were related more to economic management. It was to be hoped that the Chilean authorities would make use of the extended arrangement with the Fund and the purchase under the compensatory financing facility to rectify the economy's long-standing financial and economic imbalances.

The staff representative from the Western Hemisphere Department, responding first to those who had expressed concern about the delay in the issuance of the supplementary papers on Chile, noted that the staff had been under a severe time constraint. The financing package for 1985 and 1986 had been agreed in principle only in the final days of June, and a number of changes in the quantitative performance criteria of the program had been required. Moreover, the authorities had taken a number of important policy initiatives, and the staff had wanted to provide as complete a description as possible of those initiatives to enable Executive Directors to reach an appropriate judgment on Chile's request for an extended arrangement.

On other matters, the staff representative recalled that press reports had suggested earthquake damage considerably greater than the $500 million estimated in the staff paper. The press reports included estimates of possible future effects on private sector production, which he considered speculative in nature, and the staff continued to stand by its own figures, which referred specifically to the costs of rebuilding over the medium to longer run. In that regard, it was important to emphasize the medium-term nature of the $500 million figure put forward by the staff. For example, a large part of the earthquake damage had been to port facilities. At present, even in the absence of cranes and other loading equipment, ports in Chile were operating at 100 percent capacity, loading and unloading with cranes that were normally part of every ship's equipment. The authorities had postponed installing some $200 million worth of new cranes and other facilities in the port until financing was available.

Having based its projections on recent trends in copper prices and interest rates, the staff was confident that it was not being overly optimistic in its projections, the staff representative observed. Of course, if the projections were not realized, further adjustment would be inevitable, perhaps along the lines shown in the alternative scenarios.

Speakers had asked whether, in the effort to recapitalize the financial system, the repurchase provisions for bad loans might not hamper the operations of banks in future, the staff representative recalled. It was not the banks themselves so much as the existing stockholders who would be purchasing the bad loan portfolio sold to the Central Bank. At present, the law provided that the dividends to be paid in future to the current stockholders of those banks would have to be fully used in order to purchase the bad debt. Put more simply, it was not a burden on the operations of the banks; rather, it was a 100 percent tax on the dividends of existing stockholders; new stockholders would not be subject to the tax.

A central concern in the comments of Executive Directors seemed to be the savings performance of the economy, the staff representative remarked. The problem was by no means a new one; and indeed, it had been mentioned at almost every opportunity during reviews of the previous two-year stand-by arrangement with Chile. Savings performance was the key to Chile's economic problems over the medium term, and the goal was to raise the national savings rate so that it was consistent with a reasonable growth performance and with a decline in the current account deficit of the balance of payments. As a number of Directors had observed, while real positive interest rates had been a feature of the Chilean financial system for a number of years, they had not been sufficient by themselves to put the economy back on the right track. The financial system had in effect to be recapitalized, in order to generate confidence within the private sector. The staff papers pointed out some of the far-reaching measures taken toward that end over the past two years as well as those contemplated under the program.

Another important element in the program was tax reform, which should aid in the effort to increase private sector savings, the staff representative considered. At the same time, the program was calling for an increase in public savings from 0.5 percent of GDP to 3.2 percent of GDP for the first year of the program; and, according to data for the first five months of the year, the public savings effort was on track. Moreover, if the increase in public sector savings for the first year were to be achieved, it would be equivalent to two thirds of the increase in those savings called for by the program through 1987; the potential for future increases in public sector savings would have to be realized through expenditure cuts rather than additional taxes. In the general

Government, 18 percent of GDP in current expenditures were social security payments and transfers to the private sector. Some three years previously, a fundamental reform in the social security system had been effected whereby all new participants in the system would contribute to private sector funds. In the Chilean case, the Government was no longer receiving social security contributions even though it continued to pay out on all previously outstanding pensions. In time, those payments would decline, and private sector funds would pay all social security benefits. The other transfers to the private sector--representing nearly 9 percent of GDP--should also decline over time with the growth of the economy and should allow the public sector to increase its savings over the next few years.

The quasi-fiscal deficits of the Central Bank had been quite large in recent years, the staff representative noted. It had been difficult in the Chilean case to distinguish between "capital losses" and "operating losses" of the Central Bank. For example, so long as Chile had a system of central bank swaps with its commercial banks, the Central Bank would not have capital losses upon a devaluation; rather, it would experience operating losses because it had to meet its swap commitments at the changed exchange rate. If, instead of swap operations, Chile had taken over directly some of the foreign debt of the commercial banks, the Central Bank, upon devaluing would have had a capital loss and not an operating loss. To the extent that, in other programs, losses of the Central Bank had been included in some general picture of the public sector deficit, they had always been referred to as "operating losses" and not as "capital losses." Recently, the Chilean authorities had taken two measures to eliminate those elements that had given rise to the operating losses. They had eliminated the preferential exchange rate for debt service payments on dollar-denominated loans, which had by far been the greatest source of the operating losses. The other source of those losses was the swap arrangement, and particularly the interest subsidy on swaps; and an effort was being made to reduce that subsidy to zero by 1986.

The Chilean authorities were well aware that the tariff level had fluctuated a number of times over the past two years, from a low of 10 percent to a high of 35 percent and back again, the staff representative commented. To ensure that the appropriate signal was being given to the private sector, legislation had been introduced whereby any future change in the uniform tariff level would have to be by law and not by regulatory measure.

The inflation target of 25 percent for 1985 was the basis for the credit policy of the Central Bank and for estimates of real growth in the economy, the staff representative from the Western Hemisphere Department remarked. In the first half of the year, inflation had certainly been running ahead of schedule; however, following the 19 percent devaluation in September, tariffs had been raised from 20 percent to 35 percent. Those had since been lowered, but the impact of that increase in tariffs on prices, together with the devaluation, had led to an increase in the monthly rate of inflation. Still, the path of inflation was not that far ahead of projections. On the basis of preliminary information for July, the staff considered that the impact on inflation of the September devaluation and the tariff increase had been carried through the economy. Each month, three measures of inflation were taken every ten days, and the samples were typically indicative of what would happen during the remainder of the month. According to the July figures, inflation was falling. Moreover, during recent discussions of inflation and the current account deficit, the staff had indicated that Chile's credit policy for the remainder of the year would need to be geared toward ensuring that inflation was brought down and that the current account deficit did not grow beyond the program level. On the basis of those discussions, the authorities had taken strong measures to lower the quasi-fiscal deficit of the Central Bank, a move that had given them ample room to make appropriate cuts in total credit expansion.

The Deputy Director of the Exchange and Trade Relations Department, responding to the concerns of some Directors about the use of the "approval in principle" approach in the case of Chile, said that the use of the procedure had originally been seen as a way to speed up financing arrangements with the commercial banks. Its use had however been considered exceptional, and the staff had followed the guidelines applicable to the "approval in principle" procedure and had first undertaken intensive consultations with all creditors to seek assurances on the financing of the program so that Chile's request for an extended arrangement could be submitted to the Board for outright approval. This had not been possible and in recommending the "approval in principle" approach, the staff had also had in mind the principle of uniformity of treatment. In other similar cases, assurances of financing had been provided as a prerequisite for a recommendation of outright approval for requests being submitted to the Board; in the Chilean case, those assurances had not been provided and since the only missing element was the financing, approval in principle was the appropriate procedure.

On questions of Fund-Bank collaboration in the Chilean case, the Deputy Director observed that the World Bank had played a role in the intensive discussions between creditors and the Chilean authorities, aimed at achieving a consensus on the financing package, not only through the granting of a structural adjustment loan but also through the extension of guarantees. Of course, the Fund's main role had been the promotion of adjustment policies that would encourage financing from other sources.

In noting the length of the proposed extended arrangement, one Director had questioned whether a two-year stand-by arrangement might not have been preferable, the Deputy Director recalled. In its recommendation for a three-year arrangement, the staff had been guided by two considerations: the first was a concern that a shorter arrangement might have sent the wrong signal that Chile's problems--which were essentially medium-term difficulties--could be solved in too short a period of time; the second was the view that a longer period for the arrangement would give a greater assurance of policy continuity.

Finally, the Deputy Director of the Exchange and Trade Relations Department assured Mr. Fujino that when the staff stressed the importance of exchange rate policy in a program, it was by no means viewing an active exchange rate policy as a substitute for inadequate demand management policies. The program contained a fairly strong demand management package, and the notion of continuous vigilance on the exchange rate front had mainly been in response to the staff's concern that the Chilean economy was relatively vulnerable because of its dependence on copper and its high debt. The recommendation was indicative of the staff concern that, if developments were to evolve less favorably than currently envisaged, the authorities would be well advised to prepare themselves for more active management of the exchange rate.

The staff representative from the Research Department, responding to queries on Chile's request for a purchase under the compensatory financing facility, observed that the effect on the shortfall of the amended projections for 1985-86 was minimal for essentially technical reasons. If the calculations for a shortfall based on calendar year 1984 were reassessed in light of the latest projections, the shortfall would narrow from SDR 240 million to less than SDR 170 million. The fact that exports in the first quarter of 1985 had remained depressed had had the effect of making the export profile through the year ended March 1985 quite similar to that through calendar year 1984.

On Mr. Dallara's concerns about whether or not Chile's request met the requirements that the shortfall should be temporary and beyond the control of the authorities, the staff representative noted that the staff's judgment had been strongly influenced by the fact that the shortfall had been largely accounted for by price variation and not by volume variation. Even for copper, exports in the shortfall year had been only marginally less than in the previous year; and the shortfall in earnings from copper had been related more to unit value than to volume. As Mr. Dallara himself had noted, the staff's analysis suggested that the capacity of a country like Chile to influence short-term price movements was rather limited. As to the temporariness of the shortfall, Mr. Dallara had correctly noted that the shortfall for the previous purchase by Chile had been overestimated. There were, of course, always risks in forecasting, and a constant effort was being made to improve the process. However, the staff continued to believe that those forecasts adopted in the Chilean case were reasonable.

Mr. Nebbia observed that Chile had already made a great adjustment effort in the context of the previous two-year stand-by arrangement with the Fund and was prepared to adjust its economy further in order to achieve, over the medium term, a more viable external position while establishing the basis for sustainable economic growth. Over the past two years, Chile had been able to overcome a domestic financial crisis--shifting a meaningful trade balance deficit into substantial surplus--reduce the current account deficit, keep inflation low by regional standards, resume economic growth, and be in compliance with nearly all the performance criteria under the program. Any suggestion that performance targets had been missed did not properly describe the adjustment effort. Most performance criteria had been more than fulfilled during 1984; where deviations had occurred, straightforward measures, including devaluations of the peso, had been taken to correct them and to strengthen fiscal performance. As a result, the public sector deficit had been held to only 1.1 percent of GDP for the first half of 1985 and a substantial increase in the trade balance had been achieved, despite a sharp reduction in prices.

A glance at the full picture of developments in the Chilean economy showed a shift in the trade balance from a deficit of US$2.7 billion in 1981 to a surplus of nearly US$1 billion in 1983 and US$300 million in 1984, Mr. Nebbia continued. At the same time, as a consequence of a sharp decline in copper prices, Chile's terms of trade had deteriorated throughout the period; and international interest rates had been well above the level assumed in the program, so that service payments to foreign creditors had been significantly larger than originally envisaged. Even in the face of such adverse developments, however, the authorities had been able to keep the program on track by introducing further adjustment measures. As recently noted by the authorities, Chile had committed itself to export promotion and to an efficient import substitution strategy. A real exchange rate at the highest level in 25 years, a level of imports currently one half that registered in 1981, a uniform tariff of 20 percent, the absence of other forms of import restrictions, and the existence of a schedule for a gradual elimination of the subsidies and of the preferential exchange rate associated with external debt payments all reflected the commitment of the authorities to adjustment.

The main policy corrections in Chile had already been implemented at a high cost in term of unemployment, loss of purchasing power in wages and salaries, and a sharp decline in real consumption and per capita incomes, Mr. Nebbia noted. Unfortunately, the external debt burden would continue to limit Chile's economic performance and stretch out the period of adjustment. As noted by a number of Directors, Chile must sharply increase its domestic savings to meet the investment needs required for economic growth, and it must reduce dependence on external financing. The current account deficit also should be narrowed; however, as was the case with the effort to increase domestic savings, export promotion and efficient import substitution would take time.

In general, the Chilean authorities recognized that the move toward export-oriented growth must be made in the context of a medium-term economic program of the sort that had been brought to the Board for consideration. Among the adjustments that would have to be taken was a major tax reform that, in spite of its short-term adverse effects on fiscal revenue, should encourage domestic savings of both enterprises and individuals.

In response to those who had indicated concern about Chile's request for a purchase under the compensatory financing facility, Mr. Nebbia remarked that the Chilean authorities were themselves clearly worried about the fluctuations in prices for copper in the international market, since Chile was heavily dependent on the export of copper. As noted in EBS/85/124, "Chile is one of the world's major copper producers, accounting for about 14 percent of total mine output and 9 percent of refined copper production during 1982-84." However, since Chile had to export copper at any price to pay its external debts, it could hardly be described as being in a position to influence short-term price movements.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal contained in the report on the 1985 Article IV consultation with Chile. They welcomed the comprehensive policy undertakings of the authorities directed at reducing Chile's external imbalances and strengthening economic growth, in support of which they approved Chile's request for an extended arrangement with the Fund.

Directors reviewed the adjustment effort that had been undertaken in 1982-83 based on a major devaluation and the pursuit of tight demand policies. The current account deficit had been reduced sharply, mainly as a result of a decline in imports. While the external adjustment had been accompanied by a steep decline in economic activity, a sharp reduction in real wages and consumption, and high unemployment, economic activity had recovered in 1984 and inflation had been kept under control. However, the current account deficit had risen again in 1984 as copper prices had declined and foreign interest rates and imports had increased. Directors expressed regret at the slippages that had occurred under the 1984 policy program at the end of the year.

Directors observed that the deterioration in Chile's external environment during 1984 and the uncertain prospects for improvement of the terms of trade over the medium term require that a major adjustment effort be pursued persistently over the medium term if the external imbalances are to be reduced to a sustainable level. In that context, Directors stressed the overriding need to achieve a major and durable increase in domestic savings if the projected growth rates of investment and GDP are to be achieved and reliance on external savings is to be reduced. Noting that the needed increase in the savings ratio between 1984 and 1987 equivalent to some 8 to 9 percent of GDP constitutes a major challenge, Directors endorsed the strategy of promoting private savings through the maintenance of positive real domestic interest rates and the prompt implementation of an income tax reform, and of strengthening public sector savings by restraining wages and other current expenditure. In that context they also stressed the importance of the restoration of full confidence in the Chilean financial system in order to achieve the needed increase in private sector savings. Directors noted with approval that the public investment program was to be financed principally with public sector savings, thus eliminating the overall deficit of the nonfinancial public sector within the period of the extended arrangement.

Directors welcomed the authorities' decision to devalue the peso in September 1984 as well as the active policy of exchange rate adjustment that has been followed since then in conjunction with the re-establishment of a low uniform tariff level free of quantitative import restrictions. Directors observed that fiscal policy, which had been managed with prudence during most of 1984, had been eased substantially in the last few months of the year. The easing had been untimely, as it had coincided with central bank efforts to control the monetary impact of the devaluation and had led to a severe tightening of credit conditions for the private sector.

Directors welcomed the authorities' decision to tighten fiscal and monetary policy in 1985, action that was necessary to reduce inflation and protect the balance of payments. They remarked that developments in the economy, especially with respect to the trade balance and the rate of inflation, should be monitored closely and the authorities should be prepared to apply greater restraint if demand pressures were to persist. In that respect, a number of Directors cautioned the authorities with regard to the implementation of the fiscal contingency program.

Directors supported the authorities' reliance on market-oriented price policies in guiding resource allocation. They pointed to the importance of keeping prices in the public sector at realistic levels and of permitting interest rates to reflect closely market conditions. In that context, they strongly endorsed the authorities' recent decision to reduce sharply central bank subsidies on swap operations. Directors noted the important advances made in re-establishing a sound domestic financial system and supported the authorities' intention to withdraw interest rate guidance by the Central Bank as the financial system regained strength.

Directors observed that the medium-term forecasts clearly indicated that Chile's balance of payments position would remain difficult, despite the very sharp decline in imports, and that the external debt service burden would continue to be very high. Chile had little or no margin for slippage on the balance of payments front, Directors noted; and, in case external conditions and developments turned out to be less favorable than assumed in the medium-term forecasts, the authorities should stand ready to implement additional domestic adjustment measures promptly. Chile could no longer rely on the availability of additional foreign savings since its debt situation was already extremely difficult.

Directors welcomed the support of the World Bank for Chile's economic program in the form of a structural adjustment loan and a cofinancing arrangement with commercial banks. They also welcomed the cooperation shown by foreign commercial banks in meeting Chile's financing requirement and noted the expectation that assurances would be available soon on the foreign financing of the balance of payments for 1985 and 1986. A prompt completion of the external financial arrangement was necessary in order to initiate the extended arrangement with the Fund.

Directors welcomed the reduction of the subsidies paid on certain external debt service payments. At the same time, they urged Chile to continue making progress to eliminate exchange restrictions and multiple currency practices.

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

The Executive Board then adopted the following decisions:

Exchange Measures Subject to Article VIII

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.

Decision No. 8030-(85/106), adopted
July 15, 1985

Extended Arrangement

1. The Government of Chile has requested an extended arrangement for a period of three years for an amount equivalent to SDR 750 million.

2. The Fund approves the extended arrangement set forth in EBS/85/122, Supplement 3, subject to paragraph 3 below, and waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

3. The extended arrangement shall become effective, not later than August 15, 1985, on the date on which the Fund finds that satisfactory arrangements have been made for the financing of the expected balance of payments deficit until July 14, 1986.

Decision No. 8031-(85/106), adopted
July 15, 1985

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Chile for a purchase of SDR 70.6 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representation of Chile and approves the purchase in accordance with the request, as of the date on which the extended arrangement set forth in EBS/85/122, Supplement 3, becomes effective.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8032-(85/106), adopted
July 15, 1985

APPROVED: April 9, 1986

LEO VAN HOUTVEN
Secretary