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IMF Concludes 2003 Article IV Consultation with Chile

On August 18, 2003, the Executive Board concluded the Article IV consultation with Chile.¹

Background

Chile's sound policy framework and strong fundamentals have shielded the country from the regional financial crisis and permitted continued, though moderate, growth. The pace of Chilean growth has largely followed that of the global economy, as Chile has successfully resisted contagion from neighboring countries' difficulties. In the context of inflation targeting, monetary policy has played an important countercyclical role, while the government's fiscal structural balance rule has allowed automatic stabilizers to operate.

Economic activity has turned up since mid-2002, with a recovery of domestic demand prompted by lower interest rates, better terms of trade, and improved consumer confidence as employment picked up after several years of stagnation. The unemployment rate remains elevated, however, and is declining only slowly from its 1999 peak. Given a still sizable output gap, inflation has stayed inside the 2-4 percent target band, with very brief exceptions, and indicators of inflation expectations confirm the credibility of the inflation targeting framework.

Monetary and fiscal policies have followed their rules-based frameworks. The central bank has maintained the accommodative stance it adopted during the first part of 2002. The low policy interest rate has kept inflation from dropping below the target band, as it was successfully

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 18, 2003 Executive Board discussion based on the staff report.

transmitted to commercial rates, fueling a recovery of consumer credit and mortgage activity. The Chilean peso fluctuated considerably in 2002, reflecting turbulence in the region. At the height of market concern about Brazil last October, the central bank announced a temporary window of potential exchange market intervention; in the event, intervention was less than the announced limits. Fiscal policy continued to aim at a structural surplus of 1 percent of GDP, which, in the context of a sizeable output gap, allowed for a modest widening of the actual deficit (to around 1½ percent of GDP).

For 2003 and 2004, recovery is expected to gather momentum as slack capacity is taken up, while inflation remains close to 3 percent. Over the medium term, potential output growth should gradually increase on account of both higher capital accumulation and productivity growth, on the basis of recent and planned reforms. As demand recovers, the modest current account deficit will widen, but only slowly, since the terms of trade are expected to improve. As both output and copper export prices recover over the medium term, the actual government balance is projected to converge to the structural balance target.

The authorities have made progress in implementing the Pro-Growth Agenda formulated early last year. Further reform efforts have focused on ambitious measures to modernize the public administration, increase monetary and fiscal policies transparency, and reinforce the financial system. Chile also has concluded negotiations for free-trade agreements with South Korea and the United States, and such an agreement with the European Union is now in force.

Executive Board Assessment

Executive Directors commended the Chilean authorities for implementing a sound policy framework, based on inflation targeting, exchange rate flexibility, and a prudent target for the structural fiscal balance. They considered that these policies, in conjunction with other strong fundamentals, such as transparent institutions, an open trade regime, and sound banking and financial regulatory systems, have allowed Chile continued stability and economic growth in 2002.

Directors recognized that Chile's inflation targeting framework has successfully anchored inflation expectations and increased the economy's resilience to external shocks while maintaining price stability. They supported the current accommodative monetary stance, in light of the still tentative recovery in Chile and the global economy, and advised the authorities to stand ready to adjust the monetary policy stance in either direction in order to keep inflation inside its target band. They commended recent initiatives to strengthen monetary policy transparency and supported the authorities' interest in recapitalizing the central bank, which would further consolidate confidence in the independence of monetary policy and allow for a better understanding of the authorities' fiscal policy rule.

Directors observed that the floating exchange rate regime has helped the economy adjust smoothly to adverse shocks. They noted that the peso had remained flexible even throughout an episode of exceptional volatility in late 2002, during which the central bank chose to intervene in the markets.

Directors supported the central bank's decision to deepen the market for peso-denominated debt, though they suggested a cautious approach to issuing dollar-indexed debt and continuing to avoid issuing such debt at short maturities. Some Directors urged the inclusion of collective action clauses in future external debt issues, stressing the positive signal that such action would transmit to other emerging market economies, given Chile's strong position in international financial markets.

Directors underscored the importance of sustained fiscal discipline and supported the government's commitment to meeting its structural surplus target of 1 percent of GDP, consistent in the current environment with a small actual deficit. They viewed recent actions to raise taxes and lower expenditure as appropriate to achieve the fiscal objective, and in particular endorsed the recent VAT rate increase as a means to replace the tariff revenue forgone through recent trade agreements and finance additional outlays associated with social programs.

Directors noted that the structural balance rule had improved the credibility of the fiscal policy framework and the effectiveness of monetary policy. Looking forward, they agreed that reinforcing the public consensus regarding the need for the structural balance rule would be essential to sustaining it. Several Directors encouraged the authorities to consider formalizing elements of the structural balance target, including its level or procedures for measuring the balance, though others thought that greater formalization would be unnecessarily constraining.

Directors commended the authorities for the transparency of fiscal policies, as documented in the recent fiscal ROSC. They welcomed the authorities' plan to further improve transparency by presenting information on off-budget expenditures, contingent liabilities, and public-private partnerships, as well as reformulating the fiscal statistics using the 2001 Government Finance Statistics standards.

Directors endorsed the broad set of public sector reforms taken this year, including those to rationalize remuneration in the civil service, place limits on and increase the control of campaign finance, and increase the transparency of procurement procedures. They considered these reforms an appropriate response to weaknesses that had recently come to light in public governance, and urged the authorities to remain vigilant in monitoring their effectiveness. They also welcomed the authorities' efforts to improve the financial regulatory framework through legislation submitted to congress that would strengthen bank regulatory controls, exchange of information among supervisory agencies, and modernize financial transactions, and supported the authorities' intention to participate in an FSAP later this year. They commended Chile's continued efforts to combat money laundering and the financing of terrorism.

Directors considered the sizable external debt and refinancing needs of the corporate sector one possible source of vulnerability, but recognized that the central bank's liquid international reserves and the corporate sector's significant foreign assets offered assurance against instability in financial markets. A few Directors suggested that the global economic slowdown and the volatility of international capital flows was having a serious effect on Chile's well-managed economy, reinforcing the importance of greater surveillance of advanced economies.

Directors highlighted that the main challenge for Chile is to return to higher, sustained growth and to reduce unemployment. They emphasized the importance of enhancing progress to date in addressing constraints to growth and investment through regulatory, capital market, and social sector reforms, including those in the Pro-Growth Agenda. In this regard, they noted the importance of proposed steps to broaden capital market access and promote financial stability, including measures to promote venture capital, reduce transactions costs, and improve corporate governance.

Directors also noted that recent trade agreements, including with some of Chile's largest partners, should enhance growth prospects. They considered that Chile's endowment of natural resources would best serve the process of economic development when combined with a further enhancement of human capital. Though encouraged by recent growth of employment, they urged the authorities to move ahead on their commitment to make work schedules more flexible, and to consider other steps, such as introducing a more differentiated minimum wage structure, that would lower unemployment.

Directors recognized that the data received by the Fund are of good quality, timely, and adequate for surveillance purposes. They welcomed that most of the data shortcomings identified in previous consultations have been addressed.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Chile: Selected Economic Indicators

	1998	1999	2000	2001	2002	Proj. 2003
Real economy (annual percentage change) 1/						
Real GDP growth	3.2	-0.8	4.2	3.1	2.1	3.3
Unemployment (in percent)	6.2	9.7	9.2	9.1	8.9	...
Change in consumer prices (end of period)	4.7	2.3	4.5	2.6	2.8	3.3
Money and credit (year-end percentage change) 1/						
Broad money (M3)	8.4	6.0	4.7	2.9	-0.5	8.7
Bank credit to the private sector	11.2	3.0	10.7	6.7	5.1	8.3
Three-month interest rate 2/	16.4	10.7	10.8	7.2	3.9	...
External sector (in percent of GDP) 1/						
Trade balance	-2.6	3.3	2.8	3.0	3.8	4.0
Current account balance	-4.9	0.1	-1.0	-1.7	-0.8	-0.9
Capital account balance 3/	2.2	-1.1	1.5	0.9	1.1	1.1
Overall balance of payments	-2.8	-1.0	0.4	-0.9	0.3	0.2
Gross official reserves (in percent of short-term external debt) 4/	385.2	367.8	229.7	214.8	180.1	210.7
External debt 5/	40.0	46.8	48.7	55.7	60.8	60.5
Real effective exchange rate (in percent change) 6/	-6.1	-6.2	2.5	-9.5	-6.4	...
Terms of trade (annual percentage change)	-4.7	5.9	4.8	-7.9	1.9	2.5
Copper price (U.S. cents per pound)	75.0	71.3	82.2	71.7	70.8	74.9
Public finances (in percent of GDP)						
Central government balance	-0.1	-2.1	-0.8	-0.9	-1.4	-1.2
State-owned enterprise balance	-1.0	-0.2	-0.8	-0.4	-0.9	-1.0
Central bank balance (cash basis)	-1.0	-1.1	-0.9	-0.8	-1.1	-0.9
Memorandum items:						
Central government balance (official presentation) 7/	0.4	-1.4	0.1	-0.3	-0.8	-0.9
Structural balance (official presentation)	0.1	-0.8	0.1	0.9	0.7	0.8

Sources: Central Bank of Chile; Ministry of Finance; and IMF staff estimates.

1/ Unless otherwise indicated.

2/ Yield on 90-day central bank paper, in percent per annum (period average).

3/ Including errors and omissions.

4/ Based on the official figures on short-term debt (which include amortization of medium- and long-term debt due falling during the following year). These figures do not include direct trade credits.

5/ Figures do not include direct trade credits.

6/ End of period, as reported by the IMF's Information Notice System. A decline indicates a depreciation of the Chilean peso.

7/ The staff's presentation differs from the official presentation in the treatment of the operations of the Copper Stabilization Fund and the capital gains from privatizations.