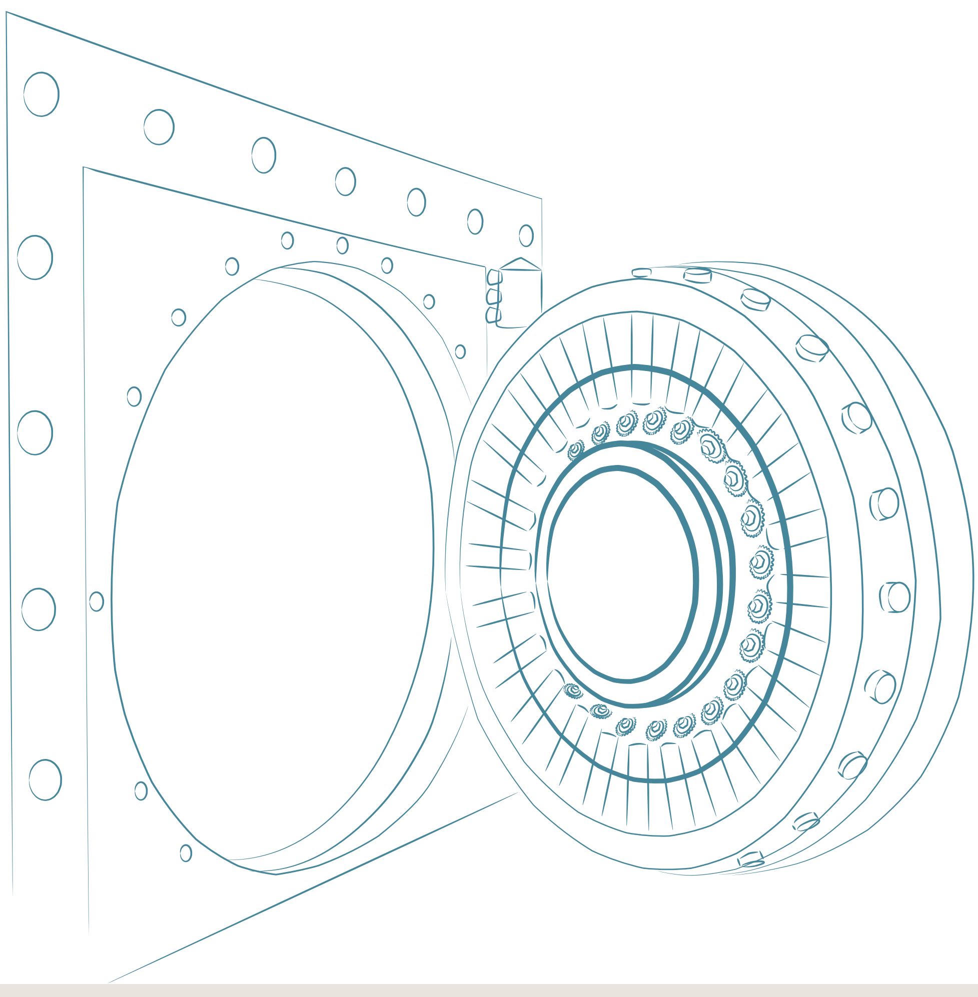
Origin of the Central Bank of Chile



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The Central Bank of Chile was created by Decree Law 486, of 22 August 1925, under the government of President Arturo Alessandri Palma. This initiative arose as one of four projects presented that year by the Kemmerer mission. That mission, which was hired by the government of the time to restructure Chile's monetary and financial system, was headed by Edwin Walter Kemmerer, professor of economics at the University of Princeton. The projects included the monetary law, which sought to stabilize the value of Chile's currency and the gold standard as the basis of the country's monetary unit, the creation of the Central Bank of Chile, the passing of the general banking law and the general budget law.

The same dispositions established in Decree Law 486 authorized the creation of an organizing commission for the Central Bank of Chile, whose express purpose was to develop the institutions necessary to ensure the functioning and management of this body, and bring it into being. Thus, the Central Bank of Chile opened its doors to the public on Monday, 11 January 1926.

The institution began activities with a nominal capital of 150 million pesos, of which about 13% was contributed by the State, 40% by Chilean and foreign commercial banks operating in Chile and the remaining 47% by the public, through a share subscription.

Ten people made up the new institution's board of directors. The President of the Republic had the right to name three, Chilean commercial banks two, foreign banks one, representative associations three, and the shareholding public one. This same board was empowered to appoint the governor and deputy governor of the Bank, with the first officers being Ismael Tocornal Tocornal and Francisco Garcés Gana, respectively. One fundamental aspect implicit in the functioning of the Central Bank of Chile, which resulted from how the board of directors had been constituted, was its ability to function autonomously and independently. From the legal point of view, this meant providing the institution with its own legal status, independent of the Government.

Despite this, the Central Bank of Chile remained subject to the general supervision of the Superintendent of Banks, created by the General Banking Law (*Ley General de Bancos*), whose original text was approved by Decree Law 559, of 26 September 1925.

In this context, the objectives of the Central Bank of Chile were essentially of a monetary nature. In the first place, the Bank was to watch over the stability of the value of Chile's currency under a fully convertible gold standard regime and, in the second place, it was to regulate currency according to the needs of the monetary market, for which the basic constitutional law assigned the Central Bank a monopoly on issuing bank notes.

Finally, the law required that the Central Bank permanently hold a gold reserve equivalent to no less than 50% of total emission. If it were to fall below this limit, it would have to pay a fine to the State proportional to the deficit.

HISTORICAL DEVELOPMENT

The first basic constitutional law of the Central Bank was in force until July 1953, when the Decree with Force of Law (*Decreto con fuerza de Ley*) 106 was approved, giving rise to the second basic constitutional law of the Bank. This new law treated the Central Bank as an autonomous institution of indefinite duration, whose fundamental objective was to "encourage the orderly and progressive development of the national economy through credit and monetary policy, avoiding any inflationary or depressive tendencies, and thus permitting the maximum use of the country's productive resources."

At this stage, then, the Central Bank began to play a more active role in developing the national economy, giving priority to the full employment of productive resources, without leaving aside its specifically monetary functions.

In this sense, the new legal text empowered the Central Bank to grant credits to the State and other state bodies. Despite the authority granted to it to carry out these operations, the Bank nonetheless was required to discount bills of exchange withdrawn by the *Caja Autónoma de Amortización de la Deuda Pública* (the body responsible for paying off public debt) and charged to the General Treasury of the Republic (*Tesorería General de la República*), in order to regularize state revenues.

Moreover, on this occasion, the presence of four parliamentarian representatives on the board of the Central Bank was ratified, and these were included during the period covered by the previous basic constitutional law.

The Central Bank's third basic constitutional law came into effect on 30 March 1960, through the Decree with Force of Law 247. This new law maintained the same objective assigned to the Central Bank in its previous legislation, but introduced several important modifications. Among others, it changed the composition and the form of appointing board members; it created the Executive Committee, consisting of the Bank governor, the deputy governor and the general manager, responsible for implementing the resolutions reached by the board of directors and managing the institution; and it expanded the Bank's powers in terms of controlling credit and setting the reserve requirements and its different forms.

Similarly, through the Decree with Force of Law 250, of 30 March 1960, the Central Bank of Chile merged with the Foreign Exchange Commission (*Comisión de Cambios Internacionales*), thus empowering the Central Bank's executive committee to dictate the general rules governing foreign trade and foreign exchange operations.

The Central Bank's fourth basic constitutional law came into force on 28 June 1975, through Decree Law 1078. The most relevant aspects of this law included the following:

a) The Monetary Council was created, as a body of ministerial rank, responsible for establishing policy governing monetary, credit, capital market, foreign trade and customs, foreign exchange, and saving operations, in line with the rules established by the Executive (central goverment).

b) The Central Bank became an autonomous institution under public law, which can only carry out those operations for which it has been expressly empowered, but which does not form part of the State administration, so in the case of any matters not covered by its basic constitutional law, the Bank and its personnel were to be ruled by private sector regulations.

c) The objective of the Central Bank was to ensure the orderly and progressive development of the national economy, through policies governing monetary, credit, capital markets, foreign trade and foreign exchange, saving and other operations, as referred to by law.

d) The Central Bank was provided with its own capital, which ceased to be divided into Class A (State), B (Chilean banks), C (foreign banks' branches) and D (public) shares, with an expropriation procedure established in the case of classes B, C, and D shares in the case of these not being acquired by the Central Bank through agreement with their owners.

e) The Central Bank was expressly empowered to grant credits to the State by virtue of special laws, but in any case it was established that the credits granted during a calendar year could not exceed the maximum of fiscal borrowing from the Bank established by the Monetary Council for that same year.

Finally, the basic constitutional law was amended by Article 27, of DL 3001, on 27 December 1979, which established that in no case would the Central Bank be allowed to acquire for itself discount promissory notes from the General Treasury or other notes of credit issued directly by the State, and nor would it be able to provide credit directly to bodies or companies from the private or public sectors, with the exception of financial institutions.

ITS NEW INSTITUTIONAL FRAMEWORK

The profound political and economic structural changes that have occurred since the Central Bank was created, both in Chile and abroad, have tended to support the greater and more effective autonomy of the Central Bank, particularly in recent years. The need for an autonomous central bank is based on the stability inherent in monetary and foreign exchange policies that are more independent of political cycles. These policies must take into consideration both the general orientation of economic policy and the mechanisms most suited to coordinating and exchanging information with the authorities involved in the executive branch of government.

In this context, Article 108 of Chapter XIII of the current Constitution of Chile granted the autonomous Central Bank constitutional rank. At the same time, this law defined it as a body with its own equity, of a technical nature, whose composition, organization, functions and attributes should be determined through a basic constitutional law of its own.

Nonetheless, legislators also established a constitutional rule, contained in Article 109 of the Constitution, that this institution could only carry out operations with public and private financial bodies. The Central Bank cannot guarantee nor acquire documents issued by the State, its bodies or companies. Nor can it adopt agreements that involve discrimination or the establishment of rules and requirements that differentiate among persons, institutions or bodies carrying out operations of the same nature, nor can it directly or indirectly finance any public expenditure or loan, except in the case of external war or danger thereof, which must be so qualified by the National Security Council.

In line with the above, on 10 October 1989, Law 18,840 came into effect. Its Article ONE established the text of the Basic Constitutional Act of the Central Bank of Chile.

Essentially, along with confirming the Bank's independence in technical and financial (equity) terms, this Act also defined the objectives to be pursued by this institution: to ensure the stability of the value of the national currency and the normal functioning of domestic and foreign payments. To achieve these objectives, a suitable macroeconomic balance must be maintained within the formulation of all policies to be projected in time.

With regard to the technical nature of the Central Bank's autonomy, this referred essentially to its ability to establish its own resolutions and make its own technical decisions while exercising its attributes. Similarly, from the point of view of equity, the Central Bank is also autonomous, since the Act granted it its own equity, which can be managed completely independently of the executive branch.

As a result of the autonomy granted by law, the Central Bank is not subject to supervision by the General Comptroller of the Republic nor the Superintendent of Banks and Financial Institutions. Nor does it form part of the state administration and it is governed exclusively by its own rules, included in its Basic Constitutional Act and some specific clauses included in the General Banking Law, and it also enjoys sole faculty for the administrative interpretation of its decisions, regulations, orders or instructions, notwithstanding the legal attributes of judicial bodies.

THE PURPOSE OF AUTONOMY: AN ECONOMIC VISION

a) The Stability of Chile's Currency

The Central Bank of Chile's current Basic Constitutional Act establishes in its Section 3 that one of the basic objectives of this institution is to look after the stability of Chile's currency. This implies avoiding a deterioration in the value of the currency as a result of the price inflation. Thus, it is the Central Bank of Chile's responsibility to ensure that inflation remains low and stable.

The importance of this objective of ensuring the stability of the country's currency lies in the costs implicit in inflation. On one hand, higher inflation tends to distort the price system within the economy and as a result the information that prices provide does not permit the efficient allocation of resources. On the other, from a distributive perspective, inflation tends to hurt those who hold more of their wealth as money, that is, the poorest sectors. Thus, higher inflation negatively affects the level of economic activity and the population's welfare.

For these purposes, the Central Bank's powers are involved in regulating the amount of money and credit in circulation and the approval of rules in the monetary sphere. This is because of the direct relationship that has been empirically established between money and prices in the long term. Thus, the application of a strict and orderly control over the quantity of money constitutes the sole form of ensuring low, stable inflation over time.

The experience of developing countries, Chile among them, suggests that one of the fundamental causes of inflation arises when the central bank finances public expenditure. Thus, the 1980 Constitution of Chile expressly prohibits this.

Similarly, the basic constitutional law of the Central Bank establishes that under no circumstances can the Bank provide a guarantee or acquire documents issued by the State, its bodies or companies.

b) Normal Functioning of Domestic Payments

Section 3 of the Central Bank's Basic Constitutional Act establishes the second fundamental objective of the Bank, which is to ensure the normal functioning of domestic payments.

The domestic payment system refers to the set of institutions and instruments that facilitate the realization of transactions within the economy. In general, this includes as its main components currency and demand deposits (checks) in banks. These are the instruments most used in transactions carried out by economic agents; a flaw in their normal functioning would affect the whole payment system, producing real damage to the economy.

Checking account deposits represent that part of the payments system that is directly linked to the financial system. In effect, one of the basic functions of the banking system is to provide the economy with a means of payment, for which it holds deposits in checking accounts, which can be withdrawn at any time at par value. If for some reason, the documents representing these deposits (checks) were to lose their value as a means of payment (for example, due to an atmosphere of general mistrust), then an important part of the payments system would be affected.

The purpose of ensuring the normal functioning of domestic payments is closely tied to the anti-inflationary objective, because if the currency loses its value very quickly (high inflation) domestic money will cease to be used, thus damaging the payment system. However, the need to watch over the payment system does not arise only from the negative externalities that its eventual failure could produce in the economy, but also in its intrinsic fragility. In effect, banks invest resources from demand deposits in less liquid assets, so that if all these deposits were to be withdrawn simultaneously, banks would face a liquidity problem. If this were to become general, thus producing mistrust throughout the financial system, the negative effects on general economic activity could turn this initial liquidity problem into one affecting the solvency of the entire banking system.

To avoid this, the Basic Constitutional Act provides the Central Bank with the possibility of serving as a "lender of last resort", that is, a provider of liquidity to those institutions that face a temporary cash flow problem. Moreover, it has regulatory powers over the financial system, mainly (but not exclusively) over those aspects related to the payment system, such as reserve rates for deposits, the power to authorize banking firms to pay interest on checking accounts, the power to authorize banking companies to provide credits related to checking accounts, and to approve overdrafts on same, among others.

Finally, the General Banking Law rules that, in the case of an institution being forced to declare itself in liquidation, demand deposits and obligations will be paid with the resources to be found in cash, deposited in the Central Bank or in the technical reserve. Thus, demand deposits are totally guaranteed and their payment is made immediately upon a bank being declared in liquidation. Thus, the role of the Central Bank is to keep the payment system functioning, providing the funds necessary to meet demand obligations of institutions that run into problems.

c) Normal Functioning of External Payments

Section 3 of the Basic Constitutional Act also establishes that the Central Bank of Chile must ensure the normal functioning of external payments.

External payments refer to the set of transactions that residents in one country carry out in another where they are not resident, and which are also registered in the balance of payments. Thus, ensuring their normal functioning means avoiding a crisis in the balance of payments, that could interrupt these transactions.

The normal functioning of external payments is of vital importance for an economy open to international trade such as Chile's. A significant part of national output is exported, while a significant proportion of the inputs and capital goods needed for domestic production is imported from the rest of the world. If, due to a financing problem, these transactions between residents and non-residents are interrupted, serious damage would be inflicted on the national economy.

With this objective, the law empowers the Central Bank to determine Chile's foreign exchange policy. Today, this means that the market determines the reference exchange rate, in the context of a free-floating exchange. The Central Bank is empowered to intervene in this market under exceptional circumstances, and must publicly inform of and justify these interventions.

Similarly, the Basic Constitutional Act establishes that the optimum scenario is one free of foreign exchange restrictions. Nonetheless, the Central Bank is empowered to establish temporary restrictions. There has been full freedom for exchange operations and international capital movements since September 1999, when the last restrictions on foreign exchange were lifted.

CENTRAL BANK POLICIES

1. Description of the Main Policies

a) Monetary Policy

Money plays an essential role in the suitable functioning of any economy. To preserve this role, the Central Bank's monetary policy must protect the value of the country's currency, the peso, seeking to keep inflation low and stable. The purpose of keeping inflation low and stable, which is how this price stability concept is interpreted in practical terms, is no mere whim of the law, but rather serves the broader objective of moving the national economy along the path of sustained growth, full employment and, in general, progress and wellbeing for the population. In fact, the Central Bank's greatest contribution to growth and progress lies in encouraging confidence in the future, which in turn is associated with price stability. This encourages saving, investment and productivity gains, all essential elements for economic growth. Low, stable inflation is, moreover, beneficial from the point of view of distribution, because it favors growth in employment and protects the income of the most defenseless sectors of society.

Monetary policy cannot influence the trajectory of long-term growth in any way other than contributing to price stability. The effects of monetary policy on economic activity and employment, in the short and medium term, arise from the different channels along which changes in monetary policy move until it actually affects inflation. Because of this, monetary policy follows a countercyclic path, which, moreover, preserves price stability, seeking to avoid extreme changes in general expenditure or domestic demand that could lead to unnecessary risk in financial markets and difficult situations in terms of recession and unemployment. In this sense, the focus of the Central Bank of Chile's monetary policy is price stability over time, taking into account the effects this policy has on economic activity and employment in the short and medium terms.

The Central Bank's concern for price stability has translated into the application of an inflation targeting monetary approach. Although a mature inflation-targeting regime can be defined in a somewhat flexible way, it must include some essential ingredients. First and foremost, it must establish an explicit numeric target for inflation in a specific period or horizon—the inflation target as such. Second, its commitment to this target must take priority over any other policy objective that could come into conflict with inflation over the specific time horizon. Third, the Central Bank must have the independence necessary to use its instruments, so it is capable of applying its monetary policy to close any foreseeable gap between estimated inflation and the inflation target. Fourth, the Central Bank must have the technical ability to use reasonable empirical models to predict inflation. Today, the Central Bank of Chile meets all these requirements.

Since 2007, the explicit objective of the Central Bank of Chile is to maintain the annual inflation of the consumer price index (CPI) around 3% most of the time, with a tolerance range of plus or minus one percentage point. This objective should be permanently achieved in a medium-term horizon of two years. The Central Bank is concerned not only with scenarios in which inflation exceeds the target in the relevant horizon, but also with scenarios in which it falls too low. The Central Bank of Chile does not aim for an inflation level below the specified range because of the risk of disinflation, which could be very costly in terms of employment and production. Moreover, the horizon is consistent with the period over which monetary policy achieves its maximum effect and is therefore the period during which monetary policy can exercise the most control over inflation.

The main merit of this regime is that, while it restricts the discretionary powers of the monetary authorities, it permits the achievement of stabilization policies. An inflation-targeting regime establishes specific objectives, providing the Central Bank with the freedom to use the instruments and policies necessary to achieve the same.

Communication with the public is optimized using a simple, easily understood indicator, able to strongly influence inflationary expectations. Monetary policy can also play a role in stabilizing output over the short term, as long as it is consistent with meeting the inflation target in the medium term.

b) Foreign Exchange Policy

In September 1999, the nominal objective on the exchange rate—represented by the presence of an exchange rate band—was abandoned, and a free-floating regime adopted. This eliminated a possible source of inconsistency in the design of the policy regime; the Central Bank's sole commitment is now to maintain inflation within the target range, as well as reflecting the authority's confidence in the market to determine autonomously the value of the national currency. In a highly volatile world of enormous openness to capital, maintaining a foreign exchange commitment is not only a difficult task, but also, as recent experience has taught, potentially very costly. A flexible approach to the foreign exchange rate eliminates this commitment, focusing Central Bank efforts on the inflation target, which becomes the nominal anchor for the economy, avoiding any possible confusion. Moreover, the floating exchange regime provides the economy with the flexibility necessary to deal with external shocks, thus facilitating corrections that otherwise could be postponed and thereby become more complex.

Foreign exchange flexibility, however, does not mean that the Central Bank of Chile cannot intervene in the market under exceptional circumstances, if it considers that the currency is moving too far away from its equilibrium value, and costly reversions could lie in the future. These interventions, however, take the form of transparent, well-founded measures, which include explicit definitions of the periods and amounts involved, as well as the clear explanation of the reasons behind these exceptional actions.

c) Financial Policy

A stable economy that enjoys sustained growth requires a solid and secure banking sector that can allocate resources with an efficient blend of risk and return, thus ensuring the functioning of the payment system.

The Central Bank is the economy's lender of last resort and as such provides liquidity to institutions that face temporary cash flow difficulties. The Central Bank also has some regulatory authority over payment of interest on checking accounts and credit ratios.

Likewise, the Central Bank has directly contributed to both completing and deepening markets. The emission of instruments indexed to changes in the exchange rate has provided the market with coverage of this risk. The exchange of promissory notes payable in coupons for zero coupon notes has satisfied the demand for longer-term instruments, as well as helping to build a zero coupon yield curve that serves as the axis for the functioning of a market in interest rate derivatives. For the more efficient development of the foreign exchange market, the Bank has also authorized interbank loans and pacts between financial institutions in foreign currencies.

Today, the risks that banks face are suitably under control. The Central Bank has gradually introduced important improvements to regulations governing the matching of foreign currency assets and liabilities, maturities and interest rates.

Externally, the maturity of the Chilean economy, along with the adoption of the floating regime, today permit full mobility of capital, with the complete elimination of controls and restrictions on foreign capital flows. Nonetheless, the Central Bank participates in regulating bank investment abroad, both in the foreign exchange sphere and in terms of financial regulation, protecting the interests of depositors in operations such as the purchase of shares and the establishment of subsidiaries and companies, or the regulation of financial investment, and international credits. In the case of this last area, the Central Bank has its own powers, as well as sharing responsibilities with the Superintendent of Banks, to establish the equity requirements and provisions for these sorts of operation.

2. Passthrough Mechanisms and the Policy Horizon

The passthrough of changes in monetary policy to the rest of the economy occurs along different channels and takes a relatively long and variable time to materialize. Thus, several mechanisms exist to ensure that a specific policy action (reflected in a change in the policy interest rate) can affect inflation and activity.

A more restrictive monetary policy approach (reflected in an increase in the policy interest rate) leads to lower private expenditure on investment and consumption and, by this route, affects the gap between aggregate demand and potential output, and ultimately, inflation. Moreover, an increase in the policy interest rate can also affect the exchange rate (causing the peso to appreciate), thus eventually causing inflation to fall in the case of imported goods, as well as affecting external demand, and the expenditure to output gap. Policy action can also affect asset prices (by changing the relative yield for different financial instruments), which can affect real wealth and by that route aggregate demand and inflation. It is possible that the supply of credit in the banking sector may also be affected, which is particularly relevant for those firms whose access to other sources of financing is closed. Finally, policy action affects economic agents' expectations, which can be reflected in their decisions regarding consumption or investment, along with determining contracts and wages.

It can take 4 to 8 quarters for inflation to react substantially to a change in the policy rate, which operates through a set of transmission channels. This period is taken into consideration in defining the reasonable time-span that the Central Bank considers as the horizon for monetary policy. For this reason, monetary policy actions are based on the expected evolution of inflation over a period of around two years and not necessarily on its current behavior. Thus, even if inflation stands near or even at 3% at a given point in time, it may be necessary to take preventive action to avoid future deviations of inflation from the target. At the same time, isolated movements of inflation outside the tolerance range may not require policy actions if there is a well-founded presumption that the movements are very short term and that there is no risk of inflation becoming unanchored from the trend.

3. Characteristics of Monetary Policy Conduction

Transparency plays a key role in the conduction of Central Bank policies. The Central Bank is not isolated from the rest of society and has enormous political responsibility, maintaining both the President of Chile and the Senate informed of its actions. In this sense, the Board's meetings with the Senate's finance commission are fundamental to keeping society informed and involved in macroeconomic policy debate and conduction, as well as ensuring that the Central Bank receives feedback on the policies applied and perceptions regarding them.

Policy decisions are made at monthly meetings, which are publicly announced six months in advance. This does not prevent, where necessary, making policy decisions at special meetings. Policy decisions are made by a simple vote of Board Members present at the meeting, with the Governor of the Central Bank empowered to cast the decisive vote in the case of a tie. The Finance Minister is allowed to attend Central Bank of Chile meetings, with a voice in deliberations, and the ability to suspend for up to 15 days the implementation of any resolution, provided this has not been decided unanimously by the Members of the Board. Once this period has expired, and provided the majority of Board Members remain in favor, the Board's decision comes into effect with the simple publication of the resolution in the *Official Gazette* (*Diario Oficial*).

The minutes of these meetings are made public on the fifth bank business day prior to the date set for the next Monetary Policy Meeting, or the fifteenth day after the respective session if fifteen days have not passed since the last Monetary Policy session. The document reports the vote of each of the Board Members on the resolutions passed during the session.

Another important element for the Central Bank's policy transparency is the publication of the *Monetary Policy Report* beginning in May 2000 and the *Financial Stability Report* since 2004.

The *Monetary Policy Report* (IPOM), which is published every four months, presents the past evolution of inflation, a base scenario with explicit forecasts for future inflation (and growth), and a statement on the risks that the Central Bank's Board perceives as potentially affecting the base scenario over a horizon of the next two years. This high degree of transparency allows focusing on inflation projections that are an intermediate target in and of themselves. Since the forecasts are contrasted with market expectations, credibility comes to depend more on whether the Central Bank reacts in a timely and appropriate manner to a change in these inflation forecasts, than whether a specific number is achieved on a given date.

The *Financial Stability Report* (IEF) is a semi-annual publication that comprises the study of the macroeconomic and financial environment in Chile and abroad, as it pertains to the stability of the financial system. It includes an analysis of the evolution of the debt and payment capacity of credit users, the situation of nonbank financial intermediaries, and the impact of alternative macroeconomic scenarios on the banking system and on the international financial position of the national economy.

4. Operational Conduction of Monetary Policy

The medium-term operational target is defined in terms of changes in the consumer price index (CPI). This indicator, however, can present a relatively high degree of month-to-month volatility, as a result of fluctuations in perishables and fuel prices. Therefore, to interpret periodic and short-term price information (up to two months), the Central Bank also considers measures of underlying or trend inflation, such as variation in the underlying CPI (the total index excluding fruits, vegetables, and fuels) maintained by the National Statistics Institute (INE).

The Central Bank implements its monetary policy by defining a target level for the nominal interbank interest rate, which is known as the monetary policy rate (*tasa de política monetaria*, TPM). To ensure that the interbank rate falls within the desired range, the Central Bank must regulate financial system liquidity (or reserves), through the use of several instruments: open market operations, buying and selling short-term promissory notes, and liquidity deposits and lines of credits (expanded facilities). These tools also include the banking reserve over deposits, although in practice the Central Bank does not use this as an active monetary policy instrument.

Open market operations take place essentially through regular auctions of promissory notes issued by the Central Bank. Banks and financial institutions, pension funds, insurance companies and mutual funds can participate in these auctions. Promissory note auctions take place in the form of a single price per auction, that is the cut-off rate applies to all the winning participants in the auction, a system known as the "Dutch type". The above encourages competition among auction participants and tends to reflect more appropriately the conditions prevailing in the marketplace. In the event of deviations from the (average) interbank rate away from the desired policy rate, for example because of a lower level of liquidity than that required, liquidity is injected to reduce the interbank rate and make it converge toward the TPM. In general, liquidity is injected by purchasing promissory notes using a repurchasing clause (REPO) overnight. In the opposite situation, when excess liquidity is present and the interbank rate is tending to fall below the target rate, the temporary excess is withdrawn by selling short-term notes. These last operations take the form of "dematerialized" documents (that is, the documents are not physically issued).

Other tools at the Central Bank's disposal are the liquidity credit line and the liquidity deposit account. Using the first, the Central Bank provides financial institutions with one-day loans without collateral, for limited amounts and by interest rate tranche. Similarly, the liquidity deposit allows financial institutions to deposit, for one day, temporary liquidity surpluses in the Central Bank and obtain a minimum return. To suitably regulate liquidity in the financial system, the Central Bank prepares a cash flow program that covers the period during which the reserve requirement is measured. To develop the cash flow plan, both supply of and demand for banking reserves, that is bank notes and coins in the power of banks and bank checking account balances in the Central Bank, are projected. Demand is of a derivative nature that basically depends on reserve rates and trends foreseen for demand and time deposits such as the behavior of currency in the hands of the public. The supply of banking reserves depends on the behavior of currency in the public's hands and the main sources of emission, including the expiry dates for promissory notes auctioned off during previous periods and other sources of monetary expansion that are more autonomous and require their own projections. These operations include the State's financial operations with monetary impact.

Once the supply and demand for banking reserves has been determined, the amounts of promissory notes to be auctioned off by the Central Bank are decided. The auctions calendar is provided to the public the day before a new reserve period begins.

Daily follow-up of the liquidity projection is essential to ensure, wherever necessary, that the operations necessary to fine tune bank reserves take place, through the REPO operations mentioned above or special sales of short-term promissory notes.

INSTITUTIONAL STRUCTURE

The current structure of the Central Bank of Chile has been defined not only by modifications to the Basic Constitutional Act, but also to changes in the national and international environment.

These changes include, because of the internationalization of the world economy, greater trade and financial integration of the Chilean economy to that of the rest of the world, and technological innovation, mainly in the field of information and communications technology.

Similarly, the new Basic Act brought a significant change to the functions of the Central Bank and in its role, which has moved from an essentially control and regulation-oriented approach to that of general supervision and policy development.

Because of this, Central Bank autonomy also had implications in terms of its own internal management and administration. This is because of the implicit commitment to society, which requires the responsible management of human and material resources essential to its work, by establishing high standards and demands in terms of efficiency and productivity.

This process has brought with it a more flexible organizational structure, a more horizontal organization, the gradual decentralization of decision-making, the application of new management policies, and the inclusion of new technologies.

FUNCTIONS OF THE CENTRAL BANK OF CHILE

To meet its objectives, the Central Bank has a series of operating functions and attributes regarding the following areas: the issue of bank notes and coins, the regulation of the amount of money in circulation and credit, the regulation of the financial system and the capital market, faculties to preserve financial system stability, functions as part of its role as fiscal agent, attributes in terms of international questions, attributes regarding foreign currency operations and statistical functions.

The essential characteristics of these functions and attributes are described below:

1. Emission: The Central Bank has the sole authorities to issue bank notes and coins. Bank notes and coins issued by the Central Bank are the sole, legally recognized medium for payment, enjoying unlimited circulation, and legal validity throughout the country.

2. Regulation of the amount of money in circulation and credit: The Central Bank can open lines of credit, provide refinancing and discount or rediscount negotiable documents in Chilean or foreign currency, for banking companies and financial firms; set reserve rates that, in proportion to deposits and obligations, must be met by these bodies and savings and credit cooperatives; cede documents from its lending portfolio or investment to banks and finance companies or acquire from same documents for its lending or investment portfolios, and finally, carry out actions on the open market.

3. Regulation of the financial system and the capital market: The Central Bank is empowered to regulate the deposit of the public's funds by banking or finance companies and savings and credit cooperatives; to set the maximum interest rates that can be paid by these bodies on demand deposits; decide the rules and limitations on banks and finance companies in terms of guarantees and warranties in foreign currency; establish the ratios between asset and liability operations on the part of banking firms, finance companies and savings and credit cooperatives; regulate the functioning of compensatory bodies; and authorize indexing systems to be used in credit operations involving Chilean currency by banks, finance companies and savings and credit cooperatives. In credit operations using Chilean currency that does not form part of these bodies, any kind of indexing system may be agreed upon, without the approval of the Central Bank.

4. Faculties to ensure the stability of the finance system: These attributes include two essential elements: the first is providing banks and finance companies in the case of urgency and for a period of no more than 90 days, when these face a temporary liquidity problem, with operations that fall within the function of lender of last resort that corresponds to central banks; and second, grant credits or acquire assets from these same bodies when a contract has been proposed or these have been declared in bankruptcy.

5. Bank functions as fiscal agent: The Central Bank, upon the request of the Finance Minister, may act as fiscal agent in the contracting of external and domestic credits and in those operations compatible with the institution's goals.

6. Attributes in international issues: The Bank has the faculty to participate and operate with foreign or international financial bodies; contract all kinds of credits abroad; issue securities and place them abroad; grant credits to international or

foreign states, central banks, banks and financial institutions, when the purpose of these credits is to meet Bank objectives; and maintain, manage and dispose of its foreign currency reserves in the country or abroad.

7. Faculties in terms of foreign exchange operations: The Central Bank is empowered to formulate and manage foreign exchange policies. Nonetheless, foreign trade policies correspond to the President of the Republic, and shall be implemented through the different ministries and the national customs service. The Central Bank nonetheless maintains information systems on foreign trade operations with regard to their foreign exchange implications (returns and export liquidation, import coverage).

8. Statistical functions: The Central Bank must publish opportunely the main national macroeconomic figures, including those of a monetary and foreign exchange nature, the balance of payments and national accounts.

ORGANIZATION

The Board

The maximum authority of the Central Bank is the Board, which is responsible for directing and managing the Bank, exercising all the faculties and attributes granted under the Basic Constitutional Act that created it.

The Board is composed of five Members appointed by the President of the Republic, with approval from the Senate. These appointments last for ten years, Members can be reappointed for another period of the same duration, and positions are renewed every two years. The Governor of the Board and the Bank is appointed by the President of Chile from among the Board Members for a period of five years, or for the lesser period remaining in his term as Board Member. The Board itself elects the Deputy Governor from among its Members and this person remains in this position for as long as his appointment to the Board lasts. Both Governor and Deputy Governor can be reelected.

The Board can only function with the presence of three of its Members and its motions must be approved by a majority of those present. In the case of a tie, the Governor of the Board casts the deciding vote.

The position of Board Member requires exclusive dedication and is not compatible with any other activity, remunerated or otherwise, in the private or public sectors, except for teaching or academic labors.

Board Members can be removed through accusation to the Court of Appeals of Santiago, based on the argument that the respective Board Member has intervened or voted on resolutions that influence credit operations, investments or other business in which he or spouse, or relatives to the third degree or the second degree once removed, have a proprietary interest; or in which the Board Member has been involved in conduct that involves an abuse of his quality as such in order to obtain for himself or third parties, direct or indirect benefits.

Similarly, the President of the Republic, with prior approval of the Senate, can remove a Board Member who holds the position of Governor of the Bank, upon receiving a well-founded petition from at least three Board Members, for reasons of incompliance with the policies adopted or the rules applied by the Board.

Finally, the President of the Republic, also with prior approval of the Senate, is empowered to remove any or all Board Members, based on a situation where the Board Member in question has voted for Bank motions that imply a grave and obvious incompliance with its objectives and provided that this motion has been the main and direct cause of serious damage to the country's economy.

CENTRAL BANK STRUCTURE

The Basic Constitutional Act of the Bank has defined the functions of the General Manager, the General Counsel and the General Auditor, as well as the Governor and Deputy Governor.

The General Manager is responsible for managing the Bank, the General Counsel must ensure that Bank motions, resolutions and contracts fall within the law, and the General Auditor must inspect and enforce Bank accounts, operations and rules. Both the General Manager and the General Counsel have the right to voice in the Board.

The basic structure of the Central Bank is flexible, so as to be able to adapt to the different requirements made of it.

OTHER INFORMATION OF INTEREST

A) Chile's Basic Monetary Unit

In 1925, the peso became the monetary unit in Chile, with a content of 0.183057 grams of pure gold. The peso was divided into 100 cents. Likewise, ten pesos made up a condor. Inflation left these fractional coins in disuse, until 1955, when a legal ruling established that obligations must be paid in whole pesos.

With the approval of Law 13,305, in 1959, which replaced the peso with the escudo as the monetary unit, starting on 1 January 1960 (1 escudo = 1000 pesos), the basic law of 30 March 1960, article 51, ruled that bank notes should express their value in escudos, one-hundredths and half-one-hundredths, as corresponded, and bear the national coat of arms. In 1973, Decree Law 231, of 31 December 1973, eliminated fractions of the escudo from accounting and documents issued as national currency. In 1975, the peso was reestablished as the monetary unit. Then, under Decree Law 1123, published in the *Official Gazette* on 4 August 1975, as of 29 September of the same year, the monetary unit again became the peso, and at that time the rate of exchange was one thousand escudos.

Today, the Bank has the exclusive right to issue bank notes and coins, and may hire, in Chile or abroad, the printing of bank notes and the minting of coins. The characteristics of notes and their security measures are established by resolution of the Board of the Central Bank of Chile, and published in the *Official Gazette.*

The Central Bank is required to withdraw from circulation any notes in poor condition. Bank notes that have been mutilated, but clearly maintain more than half of their original text, can be exchanged at the Bank for their nominal value, while those preserving a smaller portion can be exchanged for their nominal value when, in the exclusive judgment of the Bank, it can be proved that the missing part has been completely destroyed.

The Bank's Central Building

The headquarters of the Central Bank of Chile was designed by the architect, Alberto Cruz Montt. Initially, its façade in Agustinas street went from the corner of Morandé street to the location of its main entrance today. The changes applied later on, which left it in its current state, were carried out by the architects Smith Solar and Smith Miller. They also projected the façade along Morandé to bring it into line with the part looking out onto Agustinas. This last is 71 meters long.

The Central Bank of Chile is built on a property measuring approximately 3200 square meters and is considered a heritage building, because it forms part of a harmonic urban setting included in a special zone designated for conservation (the so-called *Barrio Cívico*) and also thanks to its own architectural merits. It is in fact of an eclectic neoclassical style that follows the traditional design of banking buildings, particularly those of England, which is apparent not only in its external facades but also inside, especially in the central nave, where its terminations of rails, doors and windows with bronze profiles in sight and paneling of the same material, painted dark green, are a typical part of this style.

Inside there are many valuable paintings by Chilean artists, which are distributed in the different halls and offices. The Bank also has a collection of Chilean and foreign bank notes and coins.

SENIOR AUTHORITIES SINCE ITS ORIGIN

Governors

YEARS	NAME
1926 - 1929	Ismael Tocornal Tocornal
1929 - 1931	Emiliano Figueroa Larraín
1931 - 1932	Francisco Garcés Gana
1932 - 1933	Armando Jaramillo Valderrama
1933 - 1939	Guillermo Subercaseaux Pérez
1939 - 1940	Marcial Mora Miranda
1940 - 1946	Enrique Oyarzún Mondaca
1946 - 1951	Manuel Trucco Franzani
1953 - 1959	Arturo Maschke Tornero
1959 - 1961	Eduardo Figueroa Geisse
1962 - 1964	Luis Mackenna Shiell
1964 - 1967	Sergio Molina Silva
1967 - 1970	Carlos Massad Abud
1970 - 1973	Alfonso Inostroza Cuevas
1973 - 1973	Carlos Matus Romo (1)
1973 - 1975	Eduardo Cano Quijada
1975 - 1976	Pablo Baraona Urzúa
1977 - 1981	Álvaro Bardón Muñoz
1981 - 1982	Sergio de la Cuadra Fabres
1982 - 1982	Miguel Kast Rist (2)
1982 - 1983	Carlos Cáceres Contreras
1983 - 1984	Hernán Felipe Errázuriz Correa
1984 - 1985	Francisco Ibáñez Barceló
1985 - 1989	Enrique Seguel Morel
1989 - 1989	Manuel Concha Martínez (3)
1989 - 1991	Andrés Bianchi Larre
1991 - 1996	Roberto Zahler Mayanz
1996 - 2003	Carlos Massad Abud
2003 - 2007	Vittorio Corbo Lioi
2007 - 2011	José De Gregorio Rebeco
2011 - 2016	Rodrigo Vergara Montes
2016 -	Mario Marcel Cullell

(1) 02.Jun.73 - 10.Sept.73
(2) 23.Apr.82 - 02.Sept.82
(3) 03.Apr.89 - 09.Dec.89

Board Members

YEARS	NAME
1989 - 1991	Andrés Bianchi Larre
1989 - 1993	Juan Eduardo Herrera
1989 - 1995	Enrique Seguel Morel
1989 - 1996	Roberto Zahler Mayanz
1989 - 1999	Alfonso Serrano Spoerer
1991 - 2001	Pablo Piñera Echenique
1996 - 2003	Carlos Massad Abud
1993 - 2003	Jorge Marshall Rivera
1995 - 2005	María Elena Ovalle Molina
2003 - 2007	Vittorio Corbo Lioi
1999 - 2009	Jorge Desormeaux Jiménez
2001 - 2011	José De Gregorio Rebeco
2003 - 2013	Manuel Marfán Lewis
2005 - 2015	Enrique Marshall Rivera
2009 - 2016	Rodrigo Vergara Montes
2007 -	Sebastián Claro Edwards
2012-	Joaquín Vial Ruiz-Tagle
2014-	Pablo García Silva
2015-	Mario Marcel Cullell

Deputy Governors

YEARS	NAME
1926 - 1931	Francisco Garcés Gana
1931 - 1932	Luis Matte Larraín
1932 - 1958	Luis Schmidt Quezada
1958 - 1960	Vicente Izquierdo Phillips
1960 - 1962	Fernando Illanes Benítez
1962 - 1964	Félix Ruiz Cristi
1964 - 1967	Carlos Massad Abud
1967 - 1970	Jorge Cauas Lama
1970 - 1973	Hugo Fazio Rigazzi
1973 - 1974	Carlos Vío Valdivieso
1974 - 1974	Jorge Cauas Lama (1)
1974 - 1975	Pablo Baraona Urzúa
1975 - 1976	Álvaro Bardón Muñoz
1977 - 1981	Sergio de la Cuadra Fabres
1981 - 1981	Hernán Felipe Errázuriz Correa (2)
1981 - 1982	Iván de la Barra Valle (3)
1982 - 1983	Daniel Tapia de la Puente
1983 - 1984	Fernando Ossa Scaglia
1984 - 1985	Félix Ruiz Cristi
1985 - 1990	Alfonso Serrano Spoerer
1990 - 1991	Roberto Zahler Mayanz
1991 - 1993	Juan Eduardo Herrera Correa
1993 - 2003	Jorge Marshall Rivera
2003 - 2007	José De Gregorio Rebeco
2007 - 2009	Jorge Desormeaux Jiménez
2010 - 2013	Manuel Marfán Lewis
2014 - 2015	Enrique Marshall Rivera
2015 -	Sebastián Claro Edwards

(1) 01.May.94 - 17.Jul.74
(2) 30.Apr.81 - 03.Dec.81
(3) 31.Dec.81 - 15.Jul.82

General Managers

YEARS	NAME
1926 - 1932	Aurelio Burr Sánchez
1932 - 1943	Otto Meyerholz Gallardo
1943 - 1953	Arturo Maschke Tornero
1953 - 1958	Felipe Herrera Lane
1958 - 1962	Luis Mackenna Shiell
1962 - 1970	Francisco Ibáñez Barceló
1970 - 1973	Jaime Barrios Meza
1973 - 1973	Humberto Trucco León (1)
1973 - 1985	Carlos Molina Orrego
1985 - 1986	Jorge Court Moock
1986 - 1989	Jorge Correa Gatica
1989 - 1990	José Antonio Rodríguez Velasco (2)
1990 - 1990	Julio Acevedo Acuña
1990 - 1991	Enrique Tassara Tassara (3)
1991 - 1994	Enrique Marshall Rivera
1994 - 2005	Camilo Carrasco Alfonso
2005 - 2005	Enrique Marshall Rivera (4)
2005 - 2006	Leonardo Hernández Tagle (5)
2006 -	Alejandro Zurbuchen Silva

(1) 02.Jun.73 - 10.Sept.73.
(2) Acting 09.Dec.89 - 31.Mar.90.
(3) Acting 17.Dec.90 - 19 Mar.91.
(4) 01.Sept.05 - 22.Dec.05.
(5) Acting 23.Dec.05 - 06.Aug.06.

BANCO CENTRAL
DE CHILE

ORIGIN OF THE CENTRAL BANK OF CHILE