July 2008
IMF Country Report No. 08/XXX

Chile: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with Chile, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 3, 2008, with the officials of Chile on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 18, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of July 11, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 11, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Chile.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2008 Article IV Consultation

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Markus Rodlauer and Adnan Mazarei

June 18, 2008

- ***Context***. Chile has been in many respects a model for successful macroeconomic management among emerging market economies. The authorities and staff share a long-standing consensus on the rules-based policy framework, including a floating exchange rate, that has alleviated the impact of recent shocks.
- ***Recent developments*** have been dominated by global food and oil price shocks, exacerbated by domestic drought. Annual inflation was close to 9 percent in May, but is expected to decline gradually in the second half of the year. Growth is likely to remain below trend through 2009. Chile has so far proved resilient to global market turmoil, but risks from a sharp global downturn, higher energy prices, and tightening of credit conditions for emerging markets remain.
- ***Key policy recommendations***:
  - *Policy framework and stance*. Monetary policy has been appropriately tightened, and the central bank should stand ready to raise interest rate further, if necessary, to keep inflation expectations anchored firmly to the 3-percent target. The structural fiscal surplus rule is as important as ever in shielding the economy from shocks, and room existing under the rule is being used to alleviate the impact of higher inflation on vulnerable population groups.
  - *Sovereign Wealth Funds*. Developing a long-term investment objective for Chile's stabilization fund would be useful, and benefit from an evaluation of overall copper wealth. Reinvesting the cyclical part of the funds' returns could reduce volatility in budget revenues.
  - *Capital markets*. Efforts to boost the development of Chile's capital markets could focus on lowering regulatory and tax barriers for foreign investors and consolidating public debt issuance into fewer benchmark issues. A Financial Sector Assessment Program Update could help identify vulnerabilities.
- ***Authorities' views***. There was consensus on the long-term advantages of preserving the current rules-based policy framework. The authorities felt that the framework was sufficiently flexible to deal with a severe global slowdown.
- ***Mission***. A staff team comprising M. Mühleisen (Head), N. Batini, J. Walsh (all WHD), Z. Arvai (MCM), and A. Matsumoto (RES) visited Santiago during May 19-30, 2008. Mr. Rodlauer (WHD) participated in the final discussions with Governor De Gregorio and Finance Minister Velasco. Mr. Rojas (OED) also attended the meetings.

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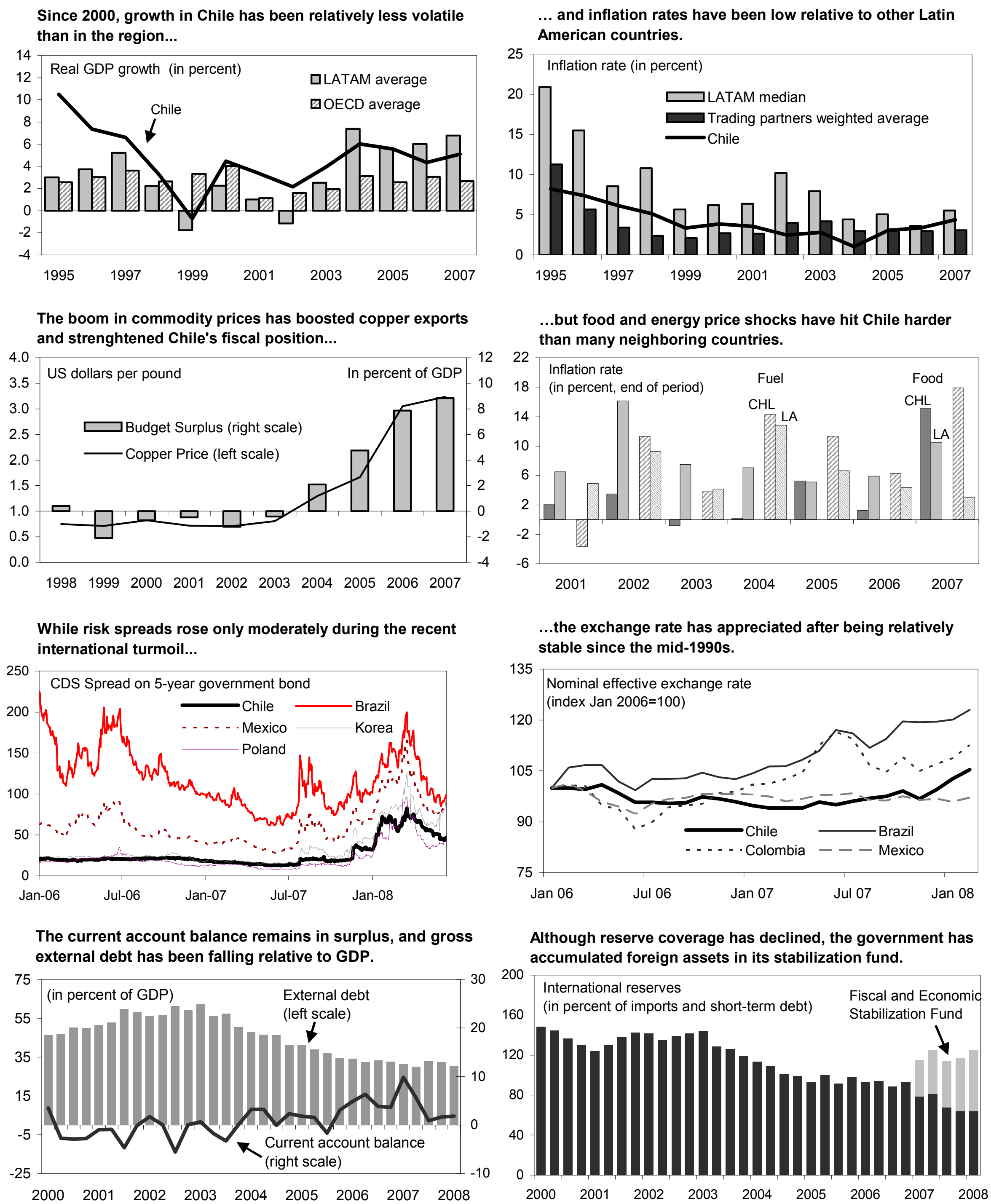

Source: Haver, IFS, Bloomberg.

I. Recent Global Shocks, Outlook, and Risks

1. ***Chile's adherence to a prudent, rules-based macroeconomic policy framework has delivered important economic and social rewards***.[1] Responsible economic policies, trade openness, and institutional reforms have helped foster growth and price stability. Real per capita incomes have increased by 3 percent on average over the past 12 years, the poverty rate has been more than halved over the same period, the public sector has become a net creditor, and Chile has begun membership discussions with the OECD.

2. ***This policy framework has helped Chile preserve economic stability through the ongoing copper boom***. Steady fiscal policy, following the structural surplus rule, has largely de-linked the economy from rising copper prices as most domestic mining revenues are accumulated abroad. This has prevented overheating, mitigated upward pressure on the currency, and led to the accumulation of a combined 15 percent of GDP worth of foreign assets in two sovereign wealth funds (SWFs).

3. ***More recently, the economy has been hit by a confluence of large domestic and external shocks that has proved more difficult to absorb*** (Box 1). Chile provides no general subsidies on food and energy, whose domestic prices have increased sharply with global price spikes. At the same time, a severe drought raised prices for local food produce and affected the production of hydroelectricity. With natural gas imports from Argentina diminishing, electricity producers have shifted to diesel fuel at a high marginal cost. As these are also being passed on, inflation has increased to close to 9 percent in May, well beyond the central bank's 3-percent target.[2]

4. ***The impact of these shocks has affected growth, and a global scenario of lower growth and higher energy prices poses further risks to the outlook***.[3] Much of the slowdown since mid-2007 is due to a drop in value-added in the electricity sector, but demand growth is also expected to slow, given past interest rate increases, tighter credit conditions, and a drop in consumer confidence despite higher fiscal transfers. However, investment has benefited from lower prices for imported capital goods and a recent rise in FDI, helping growth to stay above 4 percent in 2008. Given Chile's diversified geographical trade structure, the impact of a U.S. recession would likely be moderate, but the risk of a broader global slowdown (Box 2) and the difficult energy situation continue to weigh on the outlook.

5. ***Emergency steps have succeeded in avoiding electricity rationing, but limited energy supply will remain a challenge through 2009***. The government extended daylight

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[1] Chile maintains a floating exchange rate system free of restrictions on the making of payments and transfers for current international transactions.

[2] See also Chapter 1 of the *Selected Issues* paper.

[3] The tight energy situation is estimated to have reduced growth by about 1 percentage point.

Economic Outlook
(In annualized percent change from previous period; unless otherwise indicated)

					Projections	
	2004	2005	2006	2007	2008	2009
Real GDP	6.0	5.5	4.3	5.1	4.2	4.6
Net exports (contribution)	-1.1	-4.5	-2.1	-3.0	-2.6	-1.9
Total domestic demand	7.5	10.4	6.4	7.8	6.4	6.0
Private consumption	7.2	7.4	6.5	7.7	6.0	5.7
Public consumption	6.1	5.9	5.9	5.8	5.6	6.5
Private fixed investment	10.5	25.5	2.2	10.2	7.1	6.2
Public fixed investment	5.8	10.8	10.2	25.5	8.3	7.7
Inventories (contribution)	-0.1	-0.3	0.8	-0.6	0.2	0.0
Memorandum items:						
Output Gap	0.8	0.2	0.8	1.0	1.4	1.8

saving time and reduced network voltage by 10 percent, which—together with recent rainfall—has secured electricity supply. However, the cost of electricity generation remains at a record high, and relief is only expected from new power generation plants and an LNG import terminal becoming operational in late 2009.

6. ***Long-term inflation expectations remain anchored by the monetary framework, with inflation projected to return to target toward the end of the 24-month horizon***. Staff and authorities expect inflation to fall in the second half of 2008, helped by past monetary tightening, recent rainfall, and base effects, and then to decline gradually toward the 3-percent target by mid-2010. Despite a 50 basis point interest rate increase in June, risks remain on the upside, given the upward momentum in oil prices, a weaker peso, rising short-term inflation expectations, and still high core inflation. Nominal wages have kept pace with inflation, partly due to indexation, but unit labor cost increases have remained moderate—consistent with staff estimates that output remains currently below potential.[4]

7. ***Throughout the global financial turmoil, domestic financial markets have continued to function normally***. Given Chilean banks' low exposure to subprime mortgages, overnight spreads have risen only modestly since last fall. A recent survey confirms that most banks have tightened lending standards, although bank balance sheets remain strong amid ample funding sources. Should credit conditions in developed markets deteriorate further, however, the strong presence of foreign bank subsidiaries could pose a spillover risk (Box 3).

[4] Staff estimates that energy supply problems have temporarily lowered potential output growth to around ½ percentage point below its 5-percent trend.

General Government Budget: Staff Projections (In percent of GDP)							
	2003	2004	2005	2006	2007	2008	2009
Revenue	22.8	23.9	26.0	27.8	29.8	29.6	28.3
Mining Revenue	0.9	3.0	5.2	8.8	8.6	8.0	5.7
Expenditure	23.3	21.8	21.2	19.9	20.9	21.8	22.9
Investment	3.6	3.4	3.4	3.2	3.5	3.7	4.0
Surplus	-0.4	2.1	4.7	7.9	8.9	7.8	5.4
Net Assets	-6.7	-4.1	0.1	7.0	13.7	17.2	20.2
Memorandum items:							
Nonmining Balance	-1.3	-0.9	-0.4	-1.0	0.3	-0.2	-0.3
Nonmining Structural Primary Balance	-0.4	-1.1	-0.3	-1.2	-0.4	-1.3	-2.0

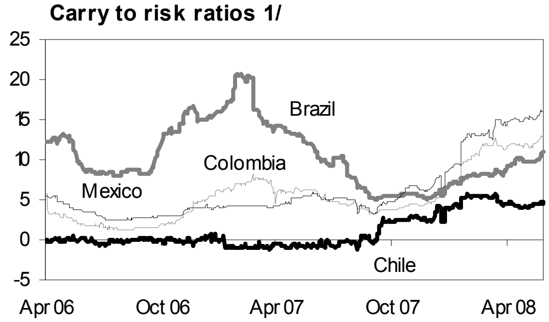
8. ***Chile's fiscal position remains exceptionally strong***. The government registered a record surplus of 8¾ percent of GDP in 2007, owing to both record-high copper prices and domestic tax revenue growth. With the reduction of the 2008 structural surplus target to ½ percent of GDP, real expenditure has been budgeted to grow by 9 percent. The 2008 fiscal surplus is likely to again reach close to 8 percent of GDP.

9. ***After a major pension reform passed Congress in January 2008, political support for new reform projects may be more difficult to obtain***. The government lost its majority in both houses of Congress, although its poll standings have improved in recent months. A report by a Presidential commission on labor and social equity provides a roadmap for further discussions; key reforms will have to find a broad national consensus in order to be implemented. Municipal elections are scheduled for October, and presidential elections for late next year.

II. Exchange Rate Valuation And External Stability

10. ***The authorities and staff agreed that the peso is mildly overvalued*** (Box 4). In 2007, the peso had strengthened in line with currencies of other emerging market economies, in particular commodity exporters. The pace of appreciation accelerated in the first quarter of 2008, reflecting widening interest rate differentials with the United States. Since the central bank's decision in April to intervene and acquire reserves (see below), the peso has depreciated by 10 percent against the U.S. dollar and is now estimated to be about 0-10 percent above a level consistent with fundamentals.

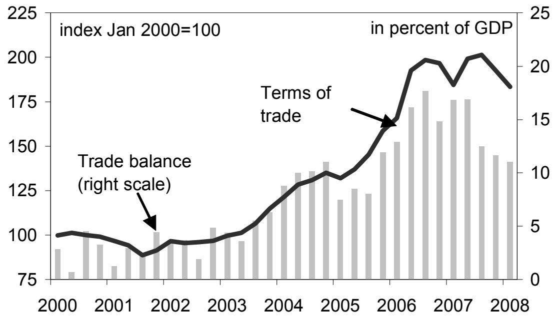
Carry to risk ratios 1/



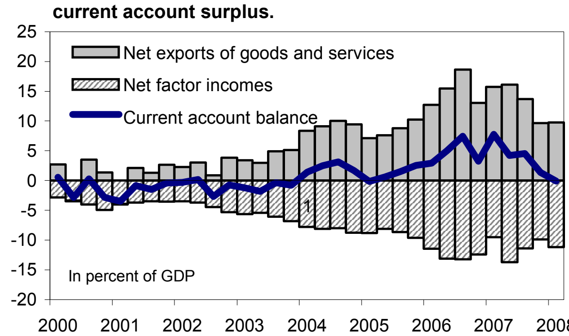
1/ Defined as the overnight interbank interest rate differential relative to the one-week LIBOR rate, normalized by the (unconditional) standard deviation over a 90-day moving average window.

Figure 2. Current Account and Capital Flows

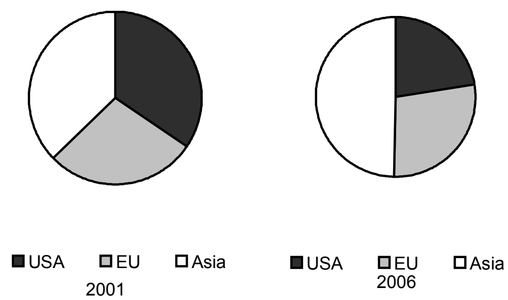
The trade balance has receded from recent highs, despite favorable terms of trade...



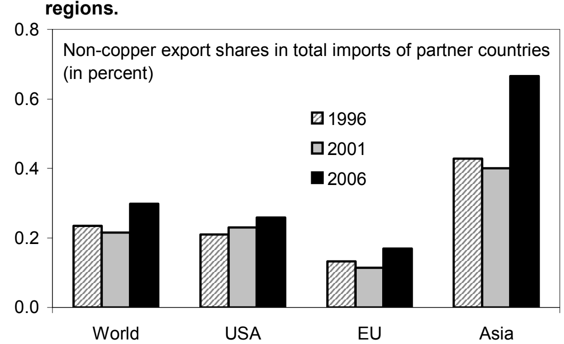
...and high profit repatriation continues to dampen the current account surplus.



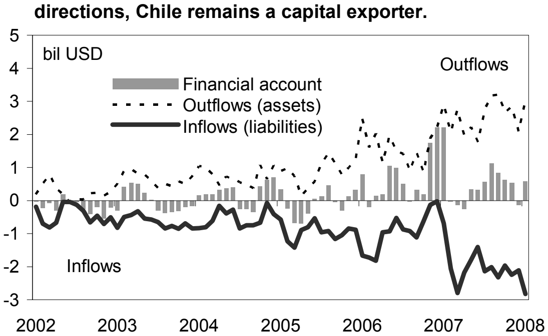
Non-copper export markets are more diversified as exports to Asia have grown...



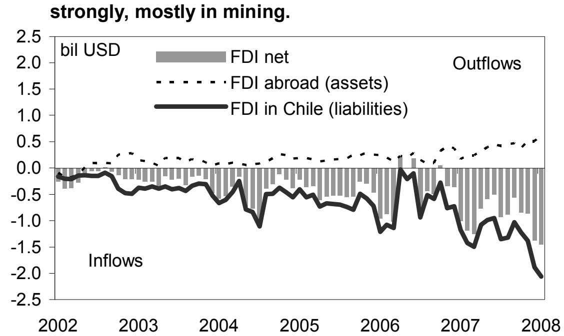
...and Chile has increased its market share in key regions.



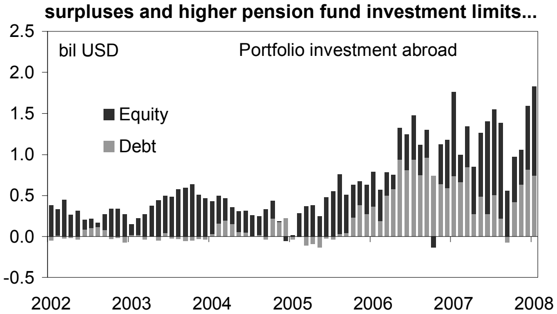
Although financial flows have increased in both directions, Chile remains a capital exporter.



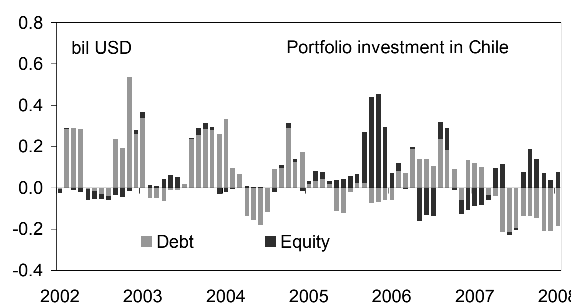
Inward foreign direct investment has picked up strongly, mostly in mining.



Outward portfolio investment has increased with fiscal surpluses and higher pension fund investment limits...



...while inward portfolio investment has declined as domestic debt issuance has shrunk.



Sources: Haver and DOTS

Underlying Current Account Balance
(in percent of GDP)

2007 Current Account	4.4	
+ Adjustments to long-run values	-6.8	
of which:		
Mining	-6.1	Net effect of mineral prices returning to long-run equilibrium.
Exports	-15.0	Export values are above the level consistent with long-run copper prices…
Profit repatriation	8.7	…and so are profits of foreign-owned mining companies (using historical relationships between exports and profits).
Mining Imports	0.3	High prices have led to increased investment and capital goods imports.
GDP Gap	-0.8	Net effect of assuming the Chilean economy at its long-run potential output.
Nonmining Exports	0.2	Slightly higher exports, in line with higher world trend growth.
Imports	-0.9	Reflecting a return to trend growth and a further rise in the income elasticity of imports.
Exchange Rate	0.4	In line with the expected adjustment in copper prices and trade elasticities.
Services and Transfers	-0.2	Declining from unusually high levels in recent years.
= Underlying Current Account Balance[1]	-2.5	

[1] Assumes exchange rate, commodity prices and output growth at long-run equilibrium.

11. ***Notwithstanding the stronger peso, export growth has remained relatively robust***. Exports to the United States have slowed, but overall growth in non-copper export volumes has remained positive. Chile maintained its global export market share in 2007, and increased its share of the Asian market by about 80 percent over the past 5 years. However, the current account surplus is expected to fall into deficit in 2008, partly as a result of continued strong import growth, including of capital goods.[5]

12. ***Chile's external position is expected to remain stable, and policies are geared toward further reducing external vulnerabilities***. The trade balance is projected to fall into deficit over the medium term as growth recovers and the price of copper declines in line with medium-term price assumptions. With a corresponding decline in profit remittances by mining companies, the current account is projected to adjust gradually to its underlying medium-term deficit of around 2½ percent of GDP—close to the CGER norm of about 3 percent of GDP. Staff expects such a deficit to be easily financed, including as a result of forthcoming capital market reforms, and continued adherence to the macroeconomic framework should help contain exchange rate volatility.

13. ***The widening of the current account deficit would be largely offset by a decline in portfolio outflows corresponding to lower government asset accumulation abroad***. A drop in copper revenues would diminish both the fiscal surplus and the amount of foreign assets acquired by the government, with private capital inflows expected to pick up only gradually on a net basis. Unlike in other emerging markets, there have been few signs of speculative portfolio flows into Chile so far, in part because domestic assets are still regarded as being

[5] While scarcity of energy and water have sharply pushed up copper production costs, copper output is expected to grow by 3½ percent during 2009 and beyond.

relatively expensive. Moreover, the liberalization of foreign investment limits for pension funds will likely lead to some outbound portfolio flows over the medium term.

14. ***The central bank decided in April to raise international reserves by US$8 billion (5 percent of GDP) by year's end***.[6] The authorities explained that the reserves buildup was designed to provide a cushion against a broader deterioration of financing conditions for emerging market economies, and with the peso appreciating rapidly and being above its long-term equilibrium, it was the right time to intervene and shore up reserves at a relatively low cost. The intervention is being implemented in a transparent, pre-announced manner (US$50 million a day), preserving the floating exchange rate regime and the flexibility of monetary policy to react to changes in the inflation outlook. The foreign exchange purchases are being sterilized at an estimated 10-year cost of ¾ percent of GDP.

15. ***The increase in foreign exchange reserves is consistent with most optimal reserve estimates for Chile***.[7] Reserves are projected to reach about 15 percent of GDP by end-2008, equivalent to about 90 percent of imports plus short-term debt. The authorities explained that assets in the government's Fund for Economic and Social Stabilization (FESS) were not fully comparable to reserves, in part because they had the different objective of stabilizing fiscal expenditure over time.

III. Policy Discussions

The policy discussions focused on three issues:

- ***Managing supply shocks***. *What is the optimal policy response to supply shocks within the rules-based framework?*
- ***SWFs and Macroeconomic Policy***. *What are the implications of SWF buildup for economic policy, and how should SWFs be managed?*
- ***Capital market development***. *With pension funds free to invest more funds abroad, what measures are needed to increase depth and competition in financial markets?*

A. Managing Supply Shocks in a Rules-Based Policy Framework

16. ***The combination of inflation targeting, a floating exchange rate, and rules-based fiscal policies remains the optimal policy framework for Chile***.[8] The authorities and staff

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[6] Separately, the government announced in May that it would purchase US$800 million (½ percent of GDP) in foreign exchange to transfer to the central bank as the third tranche under its five-year recapitalization schedule.

[7] See Chapter 2 of the *Selected Issues* paper.

[8] Chapter 3 of the *Selected Issues* paper confirms the framework's welfare-maximizing properties. Chapter 4 highlights the stabilizing impact of inflation targeting in response to global liquidity shocks.

agreed that the framework had helped the economy adjust well to recent shocks, and provided for sufficient flexibility in case of more adverse inflation or output developments.

Monetary and Exchange Rate Policy

17. ***The Banco Central de Chile (BCC) remains focused on returning inflation to target over the 24-month policy horizon***. Having raised interest rates by 125 basis points between August 2007 and February 2008, the BCC adopted a neutral policy bias in April. However, monthly inflation has since been accelerating, most core inflation measures remain outside the bank's tolerance range, and world oil prices have again turned sharply upward. In response, the bank raised interest rates by an additional 50 basis points on June 10.

18. ***Monetary policy will need to react to any further manifestation of upside risks to the inflation outlook***. Inflation remains largely driven by global commodity prices, and the BCC's latest policy action underscores its commitment to meeting the inflation target. Nevertheless, given the strong inflation increase in May and recent jump in oil prices, the authorities and staff agreed that the decline in inflation over the coming months could be more gradual than anticipated in the last *Monetary Policy Report*, possibly raising the risks of second-round effects.[9] In this light, the central bank should stand ready with additional policy measures, if necessary, to keep inflation expectations anchored firmly to the 3-percent target.

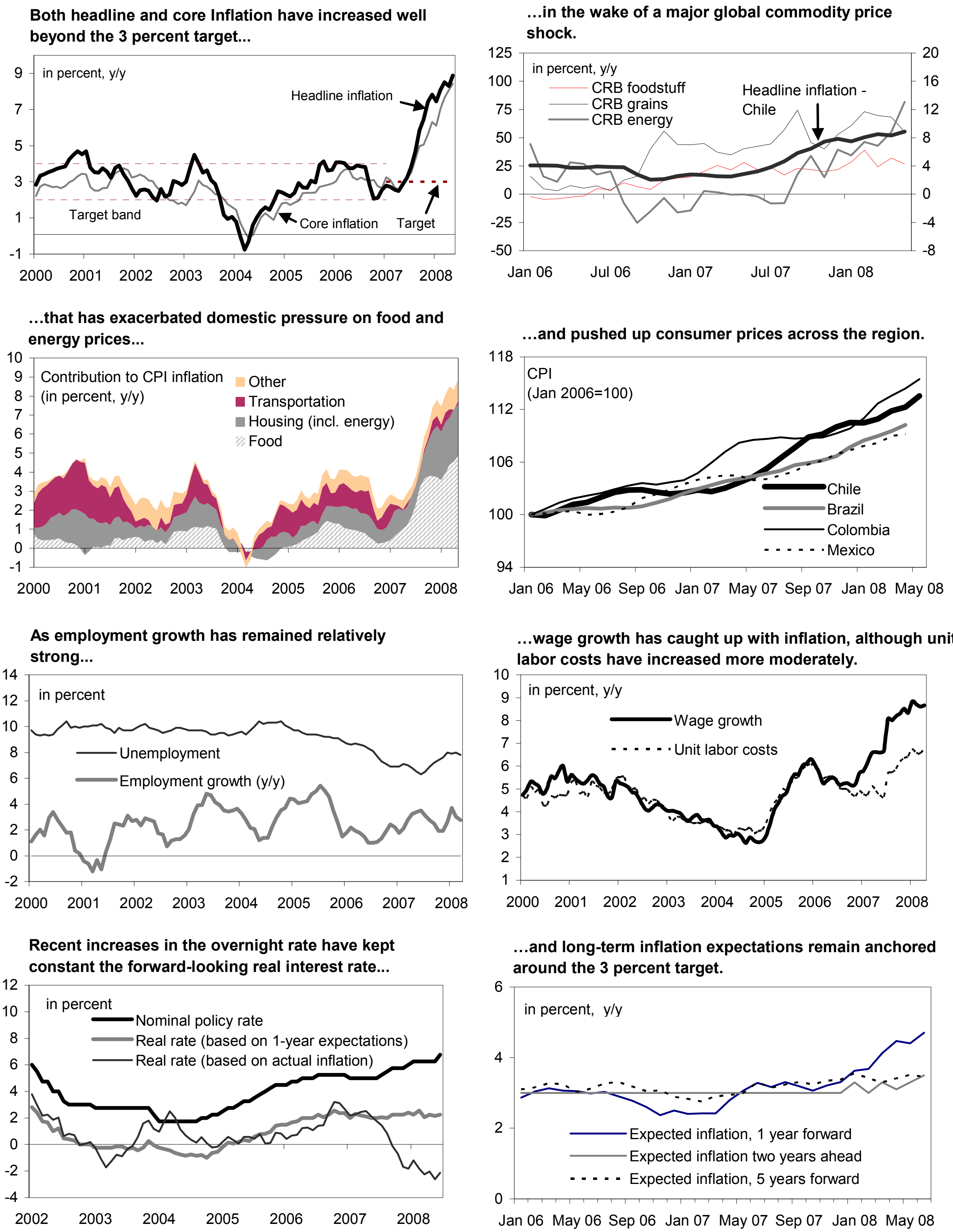
19. ***The central bank earns high marks for transparency, although communication of the inflation outlook could be improved***. Given the unusual complexity related to different supply shocks, market participants have had some difficulties disentangling first and second-round price effects, and assessing the various risks to the outlook. Providing additional information on the BCC's inflation forecast in the *Monetary Policy Report*, including on the propagation of shocks and monetary policy lags, could further strengthen the effectiveness of the central bank's policies.

Fiscal Policy

20. ***Fiscal policy has helped mitigate the social impact of inflation***. The reduction in the surplus target to ½ percent of GDP this year has provided a moderate stimulus to economic activity. This was mainly used to boost spending on education, but a pickup in nominal revenues has since provided room for ½ percent of GDP in additional spending. The government has provided targeted assistance to workers in certain export sectors, and legislation is pending to provide one-off cash transfers of $45 to the poorest 40 percent of the population and an additional $42 to low-income pensioners.

[9] The recent increase in both market and survey-based inflation expectations may partly reflect the lagged impact of past inflation (see Chapter 1 of the *Selected Issues* paper)

Figure 3. Inflation, Labor Markets and Monetary Policy



Source: Haver, Reuters.

21. ***While observing the surplus rule, the government has also used fiscal means to help the economy adjust to the rise in fuel prices***. A two-year 25-percent reduction in the excise tax on gasoline and a $200 million (0.1 percent of GDP) injection into the fuel stabilization fund have temporarily reduced the retail price of gasoline by 10 percent since the beginning of the year. The fund has also absorbed some of the high costs of substituting diesel for gas and hydro-energy as the marginal source for electricity generation. This has smoothed the impact of recent oil price shocks and helped contain headline inflation. A further $1 billion injection was announced on June 2, after the end of the mission.[10]

22. ***Looking forward, fiscal expenditure will continue to grow in line with the surplus rule, consistent with macroeconomic stability***. The government has been successful in communicating that growth of public spending beyond the limit implied by the rule risks putting renewed upward pressure on the exchange rate. The authorities emphasized that the focus of fiscal policy will be on quality and efficient implementation of spending programs.

What if the global economy turns worse?

23. ***Government officials were confident that economic stability could be maintained under worse global financial conditions***. They emphasized that central bank reserves and the FESS provided ample room to respond in case of a financial sector crisis or an abrupt decline of government revenues, respectively. In particular, the fiscal rule had been designed to stabilize public investment and social spending in case of volatile copper revenues. The government, central bank, and financial supervisors meet regularly on financial stability issues, and the authorities have been in close contact with foreign supervisors to follow developments of common interest.

24. ***The staff suggested that stepping up the recapitalization of the central bank could bolster its capacity to react in a crisis***. The central bank is currently undercapitalized by 2½ percent of GDP, and the cost of sterilizing foreign exchange purchases is likely to delay the bank's return to a positive net worth. The authorities responded that they were committed to the five-year plan approved by Congress (½ percent of GDP a year, two years remaining), after which the need for additional transfers could be reviewed by future administrations.

B. Sovereign Wealth Funds and Macroeconomic Policy

25. ***Sustained high copper prices have led to rapid asset accumulation in Chile's two SWFs***. By end-2008, the FESS will likely contain $21 billion in assets (13 percent of GDP), and another 1½ percent of GDP are held in the Pension Reserve Fund (PRF). The central

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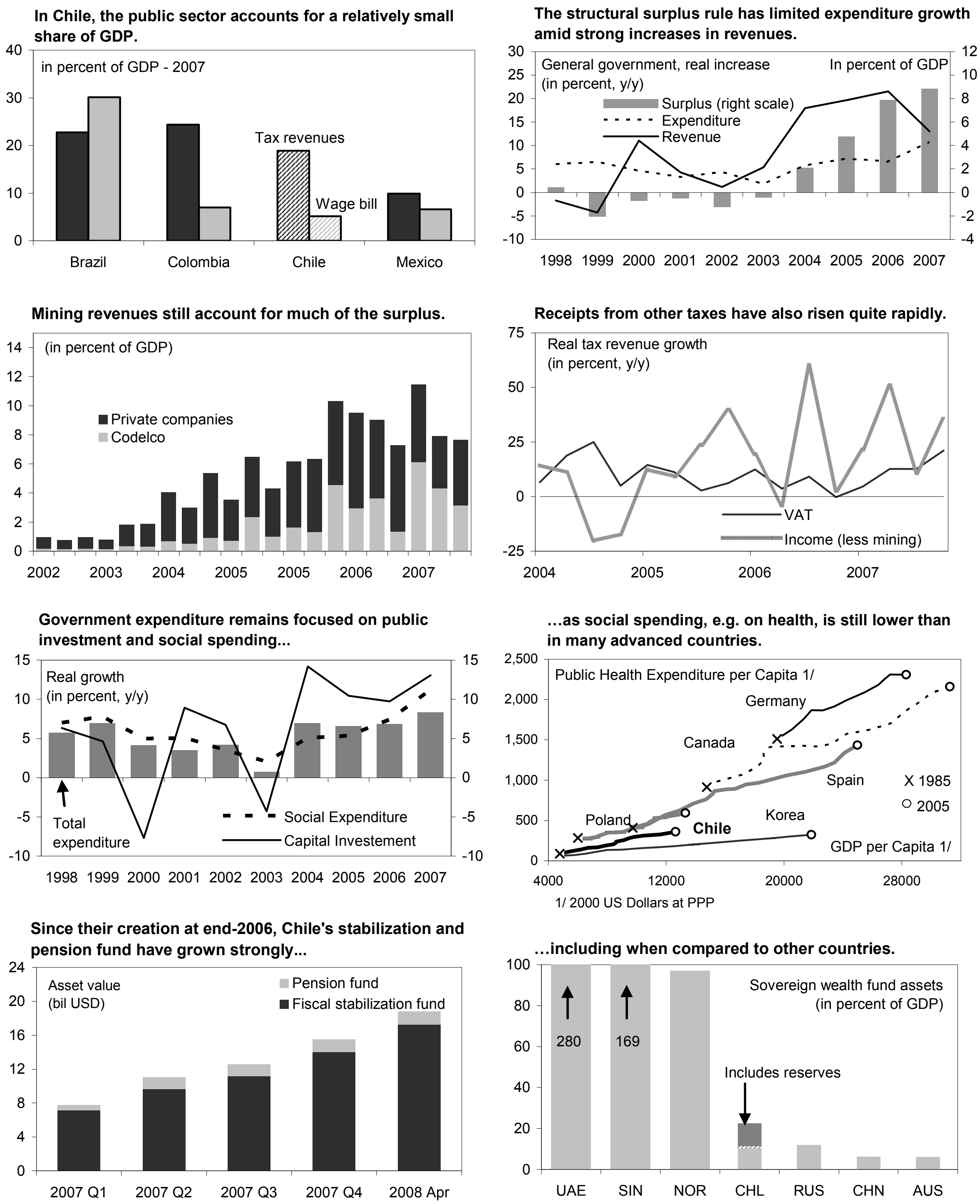
[10] Staff estimates that, on current oil price projections, US$500 million (0.3 percent of GDP) in subsidies would be spent in 2008. Gasoline nevertheless remains expensive, largely due to high taxation by emerging market standards, and pass-through of global price changes has been the highest in the Western Hemisphere. The fund is set up in such way that retail prices fully adjust to world market parity over a period of 12 months.

Figure 4. Fiscal Strength and Sovereign Wealth Funds



Source: Chilean Authoritites and Fund Staff estimates.

bank has managed both funds since their inception, following best-practice guidelines for reserves management.

26. ***The government is developing policies for managing the SWFs with a longer time horizon***. The bulk of SWF assets will be kept in highly-rated fixed-income securities, but a more diversified portfolio will also include instruments with variable and longer duration. All investments remain limited to marketable instruments, managed subject to high professional standards and full transparency.

27. ***The authorities have been working with other member countries and Fund staff on developing best practices for SWFs***. Fund technical assistance has focused on the strategic asset allocation for both funds, taking into account their assumed asset and liability structures. Significant progress has been made on the risk management framework, while the authorities agreed that performance measurement and risk management infrastructure still need to be improved.

28. ***The SWFs will provide additional resources for public spending over the medium-term***. Eventually, the FRP will contribute about one quarter of the costs of the new pension system. FESS income from asset returns—considered structural revenue under the surplus rule—is projected to rise from ¾ percent of GDP to close to 1½ percent of GDP over the next few years, including as a result of the proposed shift in the portfolio structure. The President announced in May that $6 billion are to be transferred from the FESS to a new Bicentennial Fund, with the revenue used to finance scholarships to study abroad for up to 30,000 students in the next 10 years.[11]

29. ***The staff recommended including only the funds' structural asset income in the structural revenue calculations for the budget***. As the assets and their yield grow, the cyclicality of asset returns—especially from exchange rate fluctuations—could lead to unwanted volatility in the size of the annual budget. The authorities noted that, in practice, a similar result was currently achieved by using stable and relatively standard assumptions in projecting the funds' income in the annual budget exercise.

30. ***The staff also suggested that the FESS' investment objectives be embedded in a long-term fiscal framework***. A comprehensive analysis of the structure of long-term public assets and liabilities could inform a decision whether the FESS should primarily be a stabilization or a saving fund. In this context, it would be helpful to assess the size of Chile's mineral deposits, for which no official estimates are available.

C. Capital Market Development

31. ***The ongoing liberalization of foreign investment limits for pension funds has provided an impetus for further financial sector reform***. Chile's corporate debt, equity, and

[11] See Chapter 5 of the *Selected Issues* paper.

foreign exchange markets are well developed compared to most emerging market peers. However, markets have been dominated by pension funds and other large buy-and-hold investors, and there has been little participation of foreign investors. With pension funds being allowed to invest up to 80 percent of their portfolios abroad by October 2009 (up from 30 percent until last year), the government has been planning to make domestic markets more attractive for foreign investors.

32. ***The authorities remain committed to promoting the participation of foreign investors in domestic markets***. The government is reviewing options to reduce registration and tax requirements for foreign investors in order to foster financial market integration. Staff noted that permitting the use of the peso in settling capital account transactions with nonresidents would be key for developing Chile's small derivatives markets.

33. ***A new package of financial reforms aims to boost the internationalization of the peso, increase market depth, and enhance market access for SMEs***. This package would include measures to encourage non-residents to issue peso-denominated debt in Chile, further facilitate derivatives trading, and provide a framework for the securitization of SME loans. A separate bill to establish a central counterparty for clearing and settlement purposes is already pending in Congress. The authorities expect the measures to be implemented during 2009.

34. ***The staff emphasized the importance of strengthening public debt management, including by consolidating sovereign paper into fewer benchmark issues***.[12] The authorities have made progress in developing benchmark issues, and the central bank and government are coordinating closely on debt management. Staff cautioned that debt issuance was still relatively fragmented, reflecting the varied objectives of maintaining both a nominal and inflation-indexed yield curve and providing long-duration assets for institutional investors.[13]

35. ***Supervisors were confident of the financial system's capacity to withstand financial turbulence***. Banks had appropriately tightened lending standards, capital adequacy remained strong, and bank supervisors remained in close contact with foreign counterparts to monitor cross-border activities. They have stepped up the monitoring of banks' asset quality, liquidity, and risk management, and are working toward strengthening the bank resolution framework. The authorities agreed that the scope for further market reforms and implications for financial sector stability could usefully be discussed in the context of an FSAP Update, and that market integrity could be enhanced further by providing supervisory and regulatory bodies with operational and budgetary independence.

[12] See Chapter 6 of the *Selected Issues* paper.

[13] Chile's fiscal surplus owes to dollar-denominated mining revenues that are kept in the FESS, with domestic bonds being issued to finance a local-currency deficit.

The Government's Policy Agenda

Objective: Attain GDP per capita of $20,000 (on PPP basis) by 2020.

Competitiveness	
Raise AFP foreign investment limits.	Approved in January 2008. The central bank is authorized to increase the limit from 45 percent at present to 60 percent in September 2008 and 80 percent in September 2009.
Allow tax payments for exporters in dollars.	Approved in October 2007.
Recapitalize the central bank.	The government has committed to transfer 0.5 percent of GDP in foreign currency in 2009.
Financial development	
Financial reform measures in the pension reform bill.	Approved in January 2008.
Corporate governance reform	Bill pending in Congress.
Clearing and settlement	Bill pending in Congress.
Internationalization of the peso and market deepening.	Pending
Increase public debt benchmark issuance to improve liquidity.	The Central Bank will sterilize the accumulation of US$8 billion in additional reserves by issuing indexed benchmark bonds. The Treasury will issue US$2 billion in 10-year nominal and 20- and 30-year inflation indexed bonds, an increase on the US$700 million issued in 2007.
Reform of derivatives taxation.	Legislation to be sent to Congress in 2008
Stamp tax reduction (to 1.2 percent) brought forward to	Approved in March 2008.
Competition and SMEs	
Introduce tax and tariff tribunals for dispute simplification.	Bill pending in Congress.
Simplify tax regime and reporting requirements.	Approved in 2007.
Creation of Mutual Guarantee Funds for SMEs.	Approved in May 2007.
Establish a Small Enterprise Statute.	Bill pending in Congress.
Tax credit for SME acquisition of capital goods.	Bill pending in Congress.
Elimination of tariffs on imports of capital goods.	Approved in June 2008. Expected cost around US$100 million.
Strengthening the anti-trust institutions and framework.	Bill pending in Congress.
Elimination of stamp tax for SMEs via VAT compensation mechanism.	Approved in March 2008.
Innovation	
Increase in Innovation Fund.	A 50 percent increase included in the 2008 Budget Law.
Tax credit (35 percent) for R&D investment.	Approved in January 2008.
Tax reduction (50 percent) for knowledge imports.	Approved in early 2007
Tax credit for capital gains in venture capital.	Approved in June 2007.
Extension of tax credit for trading of newly listed stocks.	Approved in June 2007.
Encourage human capital formation.	US$900 million for investment in human capital included in 2008 budget. Bicentennial Fund of US$6 billion announced on May 21, 2008, to provide scholarships for foreign study to up to 30,000 students over the next decade.
Public sector reform	
Corporate governance of public enterprises.	Bills pending in Congress.
Reduction of number of public sector employees.	Incentives for retirement provided for up to 26,000 public sector employees.
Evaluation of public sector programs.	The number of audited programs has been increased to cover 4 percent of current spending in 2007.
Fund for the Modernization of Public Management .	Pending.
Modernization of the notary public and real estate	Bill pending in Congress.

Source: Presentation by Finance Minister Velasco to Sofofa on October 17, 2007, and Ministry of Finance, Chile.

D. Other Structural Issues

36. ***The government's pension reform has been approved by Congress*** (see Country Report No. 07/333). The reform passed broadly unchanged, with a net cost of about one percent of GDP per year.

37. ***An ambitious public sector reform agenda is moving forward***. The agenda includes plans to strengthen expenditure management and reform public procurement. Staff has encouraged the authorities to move toward a formal medium-term expenditure framework (MTEF) which would help to further improve treasury management and expenditure control, and to complete passage of a public transparency bill.

38. ***The authorities have initiated legislation to modernize the governance of public enterprises in line with the OECD's Public Enterprise Code***. The bill brings most public enterprises under the umbrella of the securities regulator, subjecting them to private sector accounting and transparency standards. At the same time, legislation is being introduced to strengthen corporate governance of private enterprises, including by mandating the presence of independent board members.

39. ***A high-level commission report provides a roadmap for labor and social reform***. The commission, established by President Bachelet in 2007, proposed the introduction of a subsidy for low-income workers, in many respects similar to the principles of a negative income tax. This proposal, as well as a suggested reform of the unemployment insurance system, appear to enjoy a relatively broad political consensus. In other areas covered by the commission, such as labor relations and collective bargaining, the report provides a useful basis for further discussion.[14]

IV. Staff Appraisal

40. ***Chile's adherence to a prudent, rules-based macroeconomic policy framework has delivered important social and economic rewards***. Chile has rightly set its sights on eliminating poverty and closing the income gap with industrialized economies. The policy framework has been instrumental for managing the copper boom in recent years, and helped mitigate the impact of severe supply shocks experienced over the past 12 months.

41. ***Despite the moderate slowdown of growth, inflation risks continue to pose a challenge***. Reflecting recent shocks, output growth is projected at about 4¼ percent in 2008, and then to recover in 2009 toward potential. While inflation is projected to decline in the second half of the year, the upward momentum in global oil prices suggests that supply shocks could prove longer-lasting, and risks have shifted to the upside.

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[14] Simonovska and Söderling (WP/08/61) identified labor market rigidities as a key determinant in the decline in trend growth in recent years.

Policy Recommendations by the Presidential Commission on Labor and Social Equity[1]
(Meller Commission)

Low Income Households	· Provide a 30 percent subsidy to employed workers with monthly income up to 7.5 UF (US$ 320), split 2-1 between workers and employer. · Provide cash transfer of US$20 per child per month to families in the first income quintile. · Support civil society organizations that fight extreme poverty through public donations. · Develop a strategy for social policies at the municipal level, and reform the system used to measure poverty and social vulnerability. · Establish a body responsible for the monitoring of the consistency of social policies and in charge of performance evaluation
Workers	· Provide enhanced access to vocational training. · Reinforce programs to level adult education and strengthen development plans to train the most vulnerable fraction of the population. · Introduce measures to improve severance pay system. · Replace unemployment system based on individual accounts with a general fund. · Provide pecuniary incentives to private and public job agencies to match workers from vulnerable social strata with employers.
Women and Labor Market	· Establish post-natal subsidies to women's salaries. · Finance national day care centers through general fiscal revenues.
Labor Relations	· Create a dedicated *Labor Defense Administration.* · Increase the resources of the Labor Ministry. · Train trade union and industry representatives to foster a more technical interaction between these parties. · Establish a *Good Practice Code* for labor relations.
Young people and students	· Award prizes for best students in the public school system, including scholarships, training, and assistance in obtaining access to college. · Establish a system of grants to foster entepreunerial skills among young students. · Buttress policies that support the employment of young people, giving priority to those from low income households.
Small and Medium Enterprises	· Foster the development of goods fairs to launch and market goods produced by SMEs. · Refocus existing microfinance instruments like the subsidy to transaction costs. · Advance development of credit scoring system. · Develop a simplified financial statement requirement to account for constrains on SMEs' human capital. · Accelerate adoption of Basel II capital requirements that reduce capital requirements for SME loans. · Accelerate reform of the notary system to speed up the reform of the guarantors system.

[1] The group was commissioned to suggest policies to foster a more efficient labor market and reduce income inequality.

42. ***Monetary policy has been appropriately geared toward meeting the 3-percent target over the 2-year policy horizon***. Although real wage increases remain moderate, near-term inflation expectations have risen and core inflation measures are outside the bank's tolerance range. The central bank's recent increase in interest rates has underscored its commitment to minimize second-round inflation effects, and it should stand ready to tighten monetary policy further, if necessary, to keep inflation expectations firmly anchored to the target.

43. ***While the peso is estimated to be moderately overvalued, domestic policies remain consistent with external stability***. The central bank's decision to augment foreign exchange reserves by 5 percent of GDP has been prudent, and is being implemented consistent with Chile's commitment to a floating exchange rate. Given the additional costs of sterilization, the government could consider extending the program to recapitalize the central bank.

44. ***Fiscal policy remains well anchored by the structural surplus rule, which helps keep expenditure increases consistent with macroeconomic stability***. Staff welcomes the focus on improving the already high quality of public spending, including by increasing efficiency and strengthening governance in the public sector. The temporary use of fiscal means to alleviate the impact of higher food and energy prices is appropriate, and the staff recommends to keep the measures targeted at the most vulnerable segments of the population.

45. ***The government's efforts to further strengthen the management of Chile's SWFs are well placed***. Staff welcomes plans to invest parts of the Pension Reserve Fund and Fund for Economic and Social Stabilization into assets with variable returns, as well as Chile's contributions to developing sound practices for SWFs. An evaluation of Chile's long-term copper wealth would assist in formulating a long-term investment strategy.

46. ***To enhance the efficiency of Chile's capital markets, the authorities plan to boost competition and increase the attractiveness of local markets to foreign investors***. Consolidating public debt issuance into fewer benchmark issues and lowering regulatory and tax barriers for foreign investors would increase market liquidity. An FSAP Update could help in identifying financial vulnerabilities and further reform priorities.

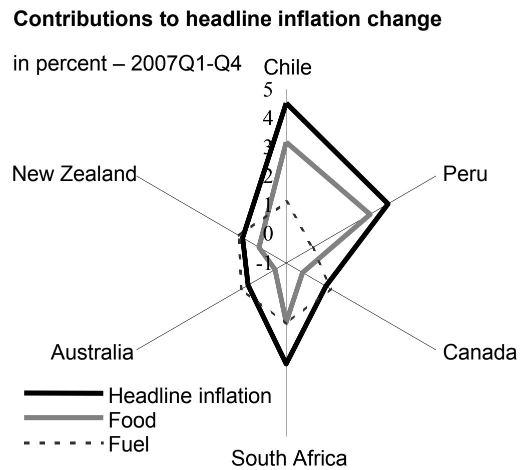
47. ***The mission encouraged the authorities to consider further labor market reforms***, building on recent recommendations by a presidential commission. Preserving labor market flexibility remains key in helping the economy adjust to major changes in relative prices.

48. ***It is recommended that the next Article IV consultation take place on the regular 12-month cycle***.

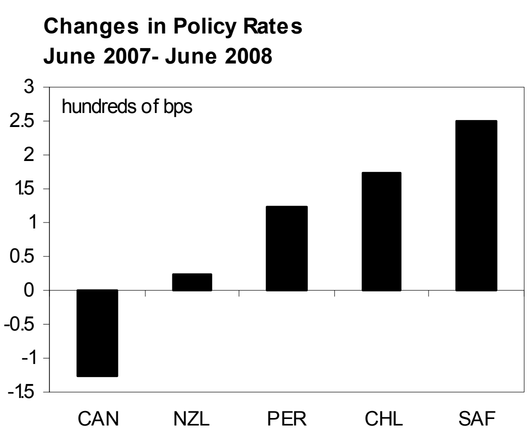
Box 1: Inflation and Exchange Rate Developments in Perspective

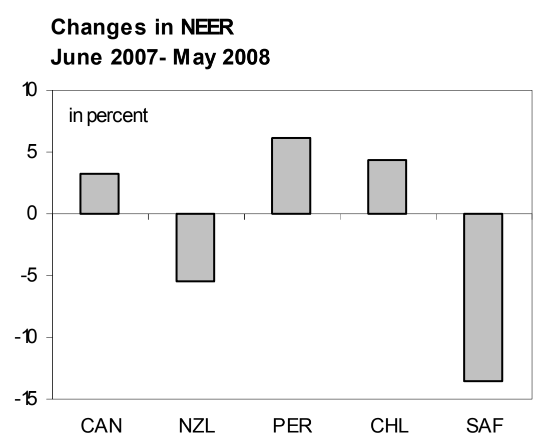
Chile's inflation rate has recently increased more than in other countries. A strong interest rate response since mid-2007 has contributed to a larger appreciation than elsewhere.

Chile's headline inflation rate was 8.9 percent in May 2008, driven by larger food and energy price increases than elsewhere. Inflation was more than double the inflation target (3 percent), and the highest level over the past twelve years. The contributions of food and fuel prices to the rise in inflation in 2007 were more than three times as large as in other Latin American countries, and even larger compared to advanced inflation-targeting countries.



The severity of the impact on Chile relative to elsewhere has two main explanations. First, the shares of food and fuel prices in Chile's CPI (27 and 4 percent, respectively) are large relative to other countries, especially advanced countries, and the absence of subsidies implies that there is high pass-through to domestic prices of these goods. Second, Chile experienced a set of additional, largely weather-related shocks to food and energy supply at home.





The Central Bank of Chile's response to higher inflation since June last year was among the most aggressive by inflation-targeting peers. This helped keep long-term inflation expectations anchored around the 3 percent target. In combination with resurgent copper prices, monetary tightening also contributed to the stronger appreciation of the peso compared to some other inflation targeters' currencies.

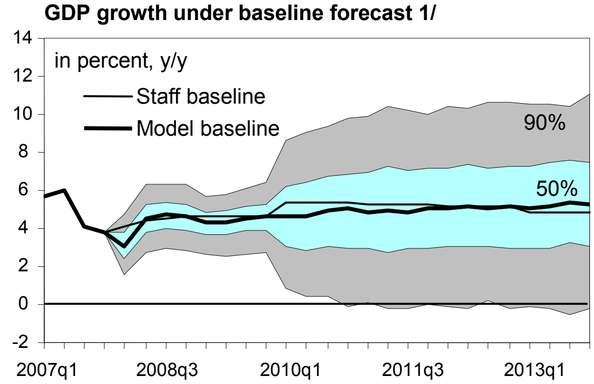
Box 2. An Alternative Global Scenario

Economic developments in Chile are closely linked to the world economy, and less to a specific trading partner. Yet, the economy appears fairly resilient to a global downturn.

The staff employs a Bayesian VAR (BVAR) model to incorporate the impact of real and financial sector linkages between Chile and the global economy into its forecasts. The BVAR relates domestic growth to world GDP, the interest rate on U.S. high-yield debt, copper prices, domestic investment, and the exchange rate.[1]

In the baseline scenario, model simulations show a strengthening of the economy after the unwinding of recent financial and commodity price shocks. Using the assumptions underlying the Spring 2008 *Regional Economic Outlook* (REO), the model produces a growth path similar to the staff's baseline forecast of 4½ percent growth in 2008 and 2009.

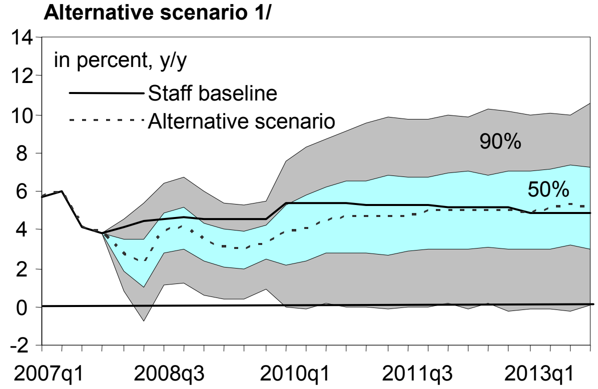
GDP growth under baseline forecast 1/



1/ Conditional path for the first 8 quarters of the forecast period; estimation sample 1994Q1 - 2007Q4.

Risks to this forecast are highlighted by a global downside scenario. Adopting the "severe downside" scenario presented in the REO, world GDP in 2008 is assumed to grow by only 2½ percent. Copper prices would drop 30 percent, and interest in high-yield debt would rise 250 basis points above the baseline. Growth in Chile could drop to below 3 percent in 2008–09 before returning gradually to trend growth. Yet, the probability of a severe recession would still appear low as the macroeconomic framework would provide for a significant countercyclical stimulus through domestic short-term interest rates, the exchange rate, and fiscal policy combined.

Alternative scenario 1/



1/ Conditional path for the first 8 quarters of the forecast period; estimation sample 1994Q1 - 2007Q4.

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[1] See Österholm, P., and J. Zettelmeyer, 2007, "The Effect of External Conditions on Growth in Latin America," IMF Working Paper No. 07/176, for a description of the model.

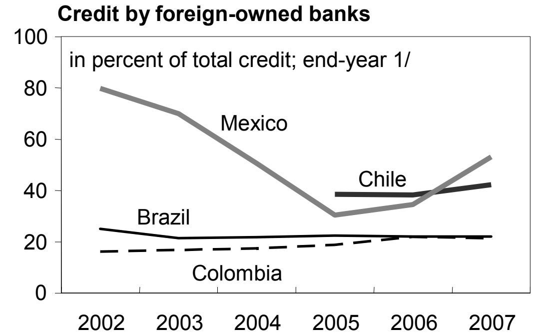
Box 3: Participation of Foreign Banks in Chile's Banking System

Foreign-owned banks account for about 40 percent of total outstanding credit in Chile, historically higher than in most of its neighbors. The concentration among parent countries creates a channel for the transmission of country-specific shocks.

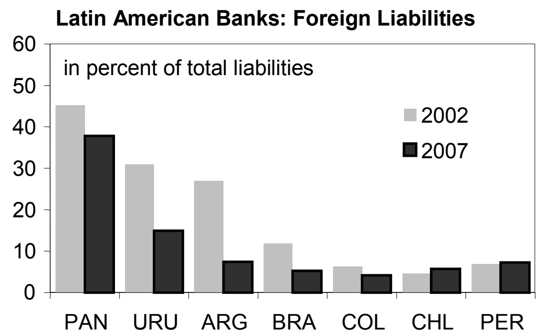
Cross-border claims of foreign banks on Chile rose by more than half to $34 billion (21 percent of GDP) over the past two years. While two thirds of the change reflect exchange rate fluctuations, there has been some increase in borrowing by domestic banks recently as pension funds are likely to shift parts of their deposits abroad. Subsidiaries of foreign banks hold $50 billion in credit on local counterparts, but the overall share of foreign bank liabilities remains low at 7 percent.

The presence of foreign banks in Chile does not appear unduly large. Although foreign banks account for a large share of the banking system, Chilean corporates have access to financing through a well-developed domestic bond market. Partly as a result, claims by foreign banks account for a smaller share of GDP than in much of emerging Europe, and are of an order of magnitude comparable to countries such as Korea and South Africa.

However, geographical concentration among foreign banks could provide a possible transmission channel for financial shocks. In recent years, Spanish banks have significantly increased their presence in Chile, and European institutions now account for about 80 percent of consolidated claims on Chile. Hence, there may be a risk that tighter credit or liquidity conditions in Europe would be transmitted—possibly through local subsidiaries—into the Chilean market.



Sources: National authorities; and IMF staff estimates.
1/ For 2007, rates are based on latest available data.



Sources: IMF, International Financial Statistics

Claims by Foreign Banks

(percent of GDP; as of Sept. 2007)	Cross-border	Consolidated
Czech Republic	24.5	89.6
Hungary	51.1	84.9
Poland	22.6	49.7
Chile	18.3	42.3
Mexico	10.2	34.7
Brazil	11.2	20.2
Colombia	9.3	14.1
South Korea	19.6	32.6
South Africa	12.7	39.1

Source: BIS.

Origin of Foreign Claims on Chile

(in percent)	2002	2007
Spain	48.0	59.4
United States	17.4	12.0
Germany	9.6	7.2
Netherlands	4.2	6.1
United Kingdom	3.8	3.1
Other	17.1	12.1
Total	100.0	100.0

Source: BIS.

Box 4. Assessing Chile's Exchange Rate

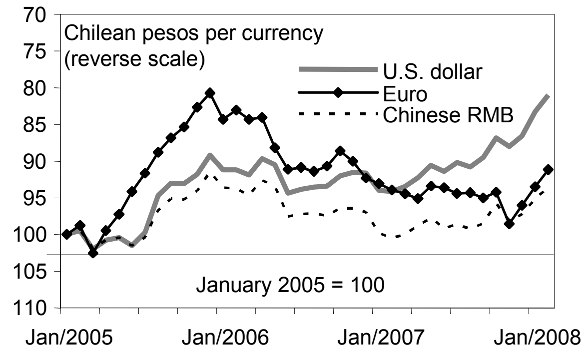
The IMF's multilateral CGER approach finds the peso valued at about equilibrium. Other models by the authorities and staff estimate the peso to be about 0-10 percent above a level consistent with fundamentals.

On a real effective basis, two factors have added to the appreciation of the peso in recent months. First, the rise in Chile's inflation differential with its trade partners has made domestic goods relatively more expensive. Second, Chile's trade with Asia has increased. With price levels in Asia below those in Chile, the United States, and Europe, the peso has become less competitive.

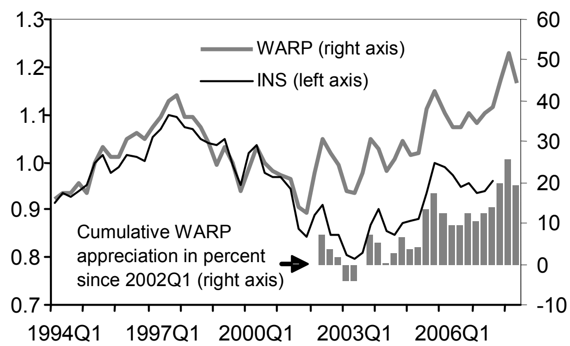
Both factors are captured in a real effective exchange measure developed by the U.S. Federal Reserve Board.[1] The Weighted Average Relative Price ("WARP") is calculated using relative purchasing powers and shifting trade weights—and is thus well suited for a country like Chile. According to this measure, the peso has appreciated by around 19 percent since early 2002.

In estimating a WARP-based equilibrium exchange rate approach, using variables similar to those in the CGER model, we find that terms of trade shifts (particularly higher copper prices) account for most of the appreciation in recent years. As of May 2008, the peso was valued at about 8 percent above the level predicted by fundamentals. This estimate is within the range of model outcomes obtained of the authorities.

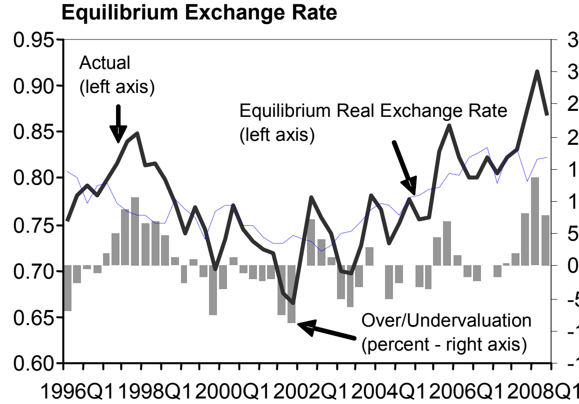
Nominal Exchange Rates



Comparison of Real Exchange Rates



WARP Real Exchange Rate and Predicted Equilibrium Exchange Rate



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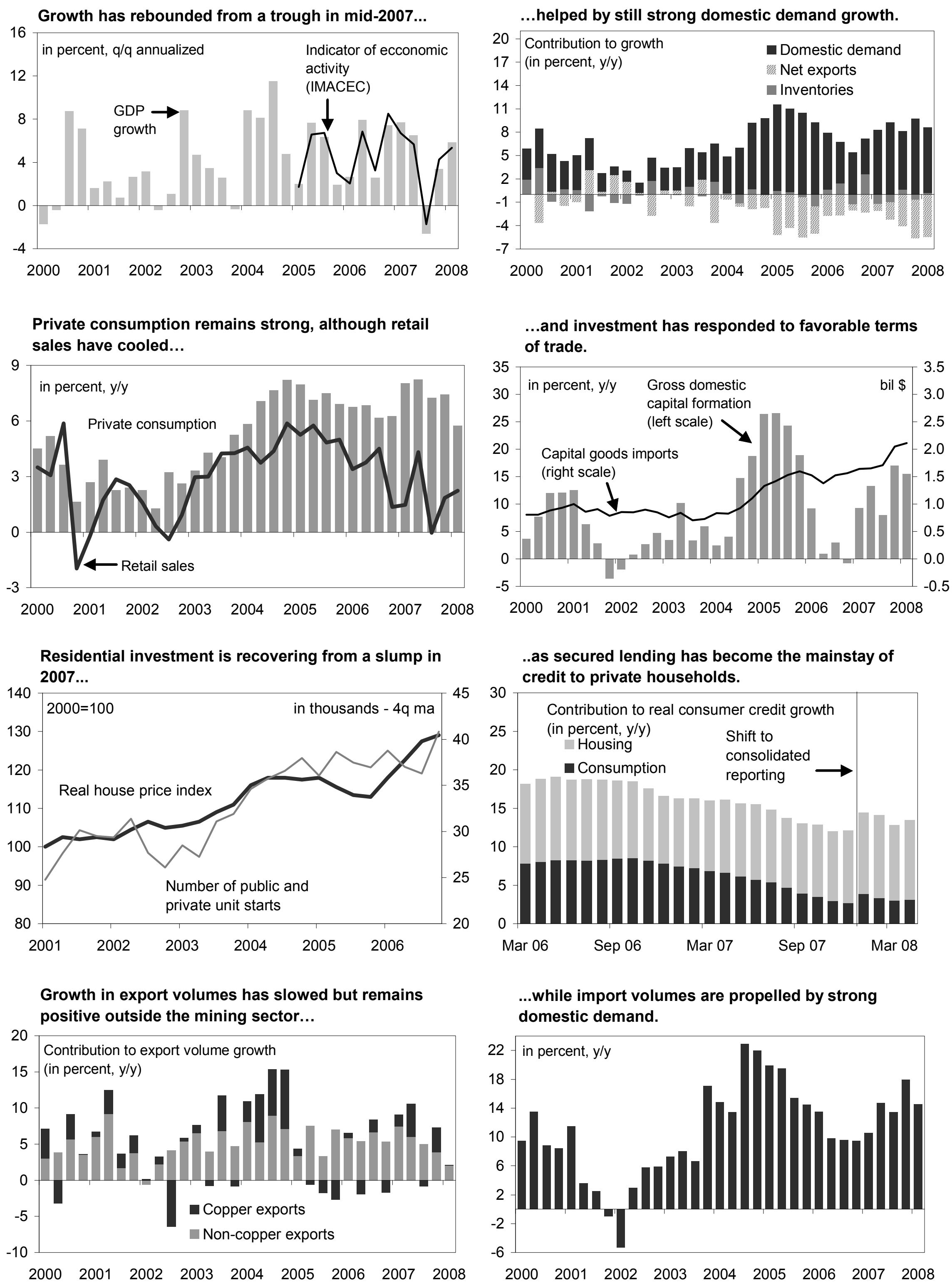
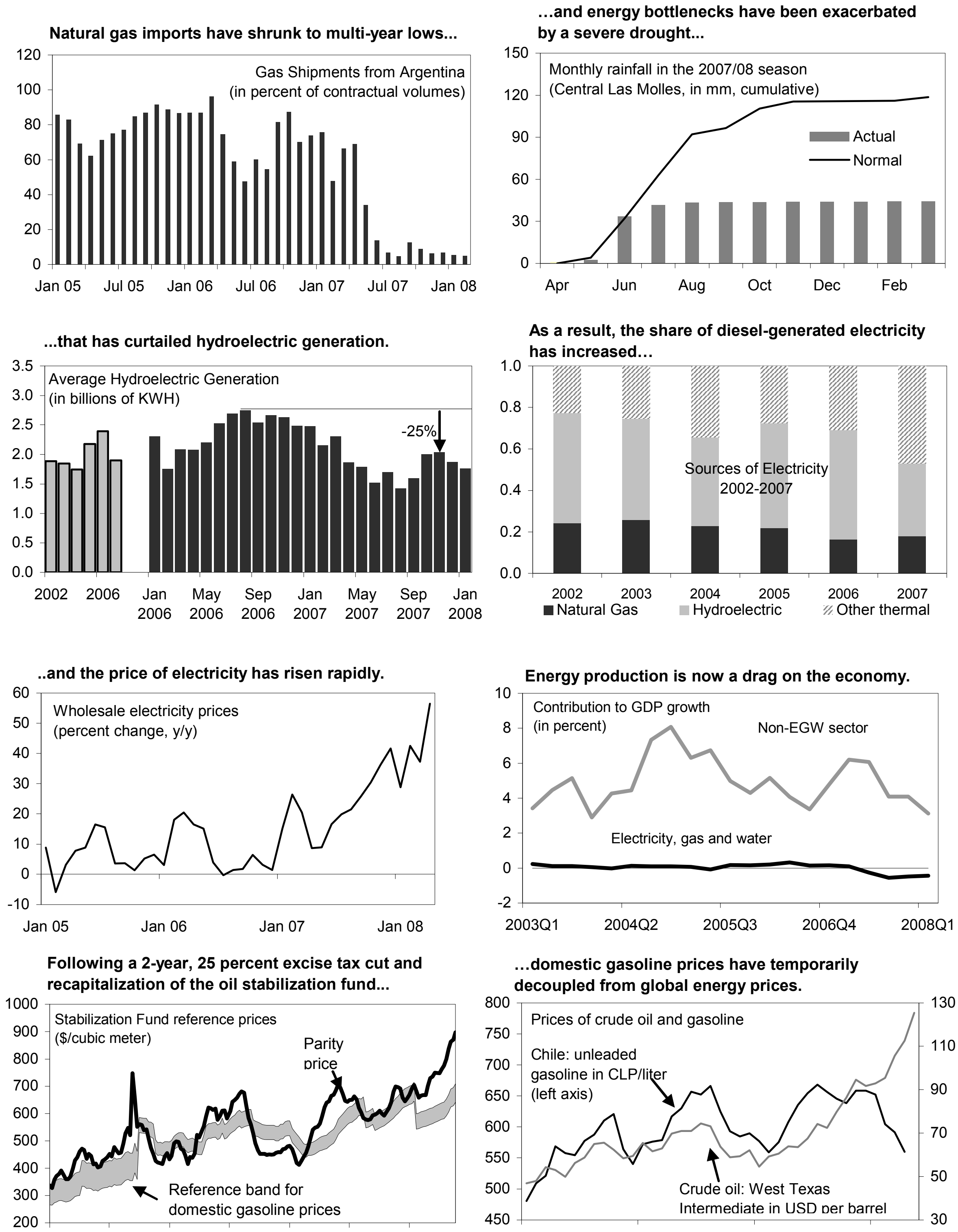
[1] Thomas, C.P., J. Marquez, and S. Fahle, "Measuring U.S. International Relative Prices: A Warp View of the World," FRB International Finance Discussion Paper No. 917, 2008.

Figure 5. Domestic Demand and Net Exports



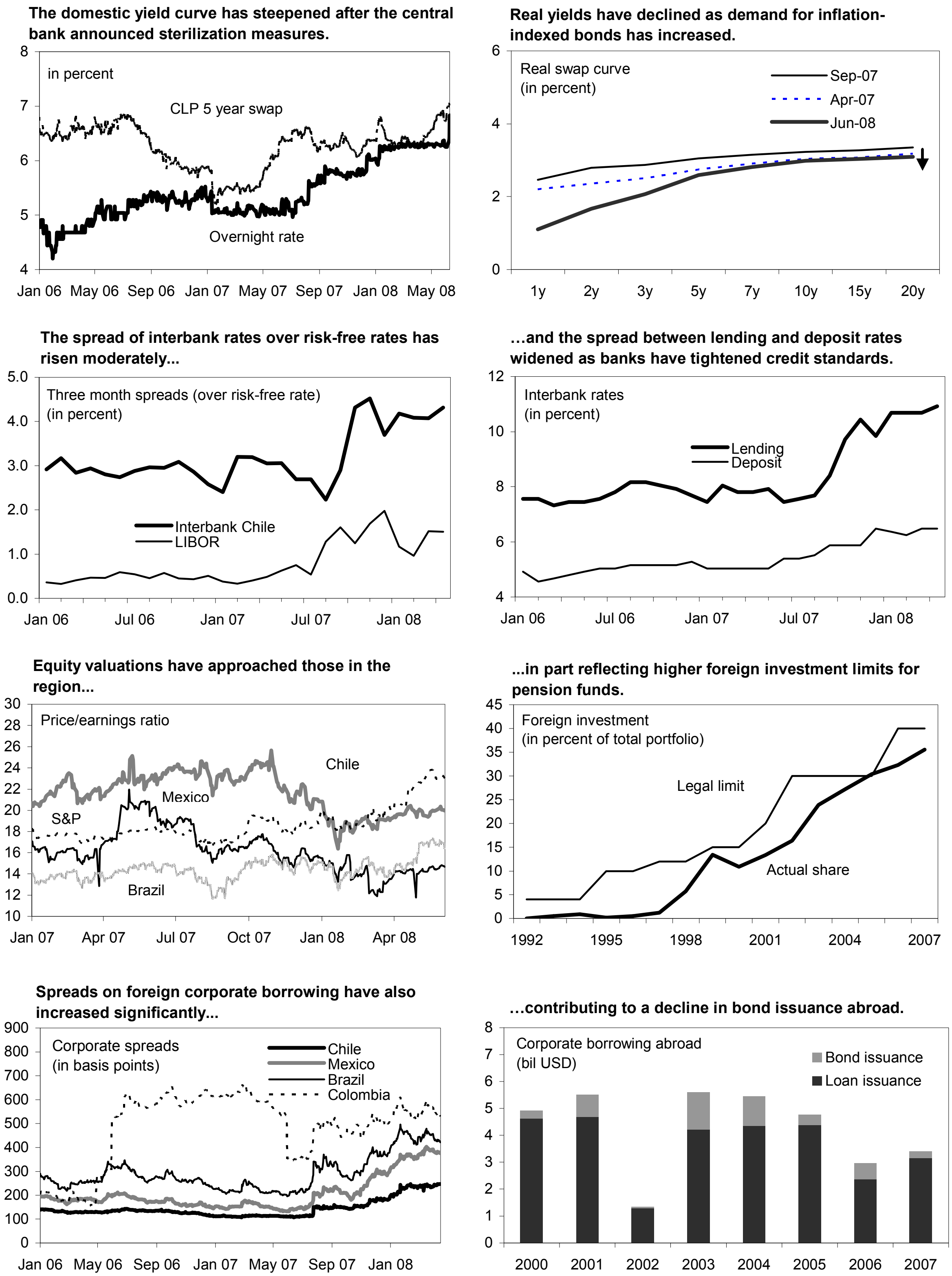
Source: Haver, Chilean Authorities and Fund Staff estimates.

Figure 6. Energy Supply: Tight and Expensive



Source: Chilean Authorities

Figure 7. Yields, Spreads, and Credit



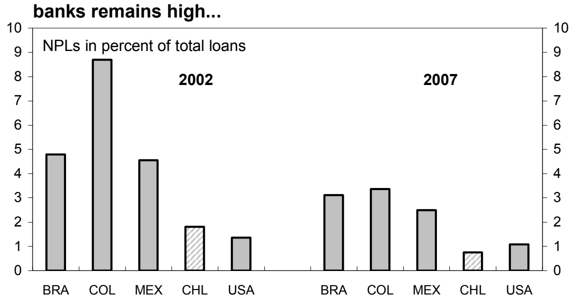
Source: Bloomberg, Haver, Credit Suisse, BEL and Chilean Authorities.

Figure 8. Developments and Key Players in Financial Markets

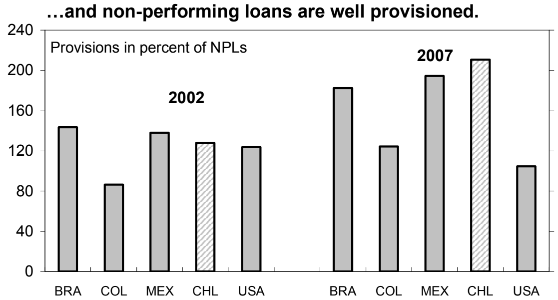
Source: Bloomberg, Bankscope, Bank of International Settlements, IFS, World Federation of Exchange Rates and Fund Staff estimates.

Figure 9. Healthy Banking Indicators

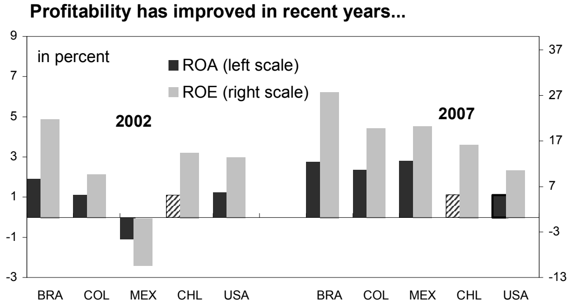
Amid strong credit growth, the portfolio quality of Chilean banks remains high...



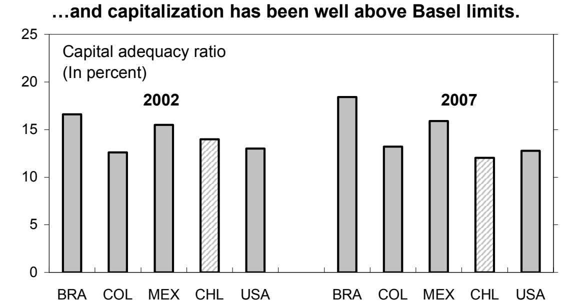
…and non-performing loans are well provisioned.



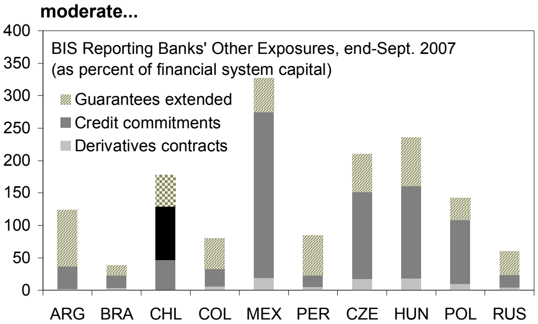
Profitability has improved in recent years...



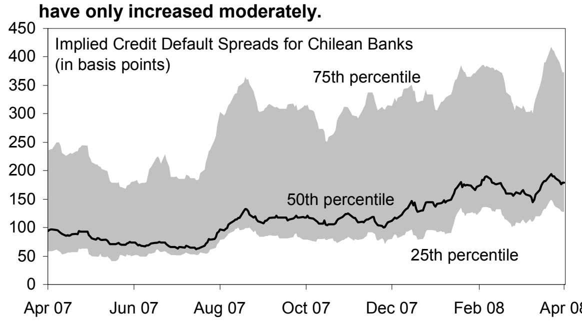
…and capitalization has been well above Basel limits.



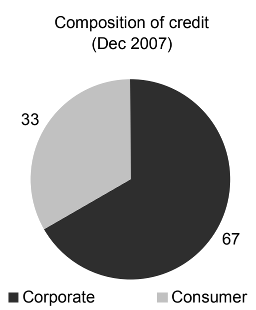
Off-balance sheet exposures of Chilean banks are moderate...



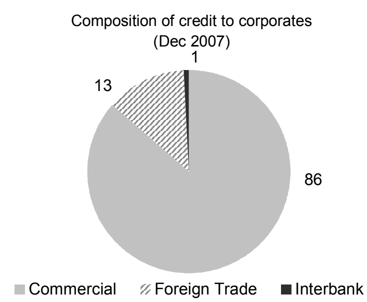
…and in the wake of global financial turmoil, risk indicators have only increased moderately.



Credit to corporates dominates bank borrowing by households.

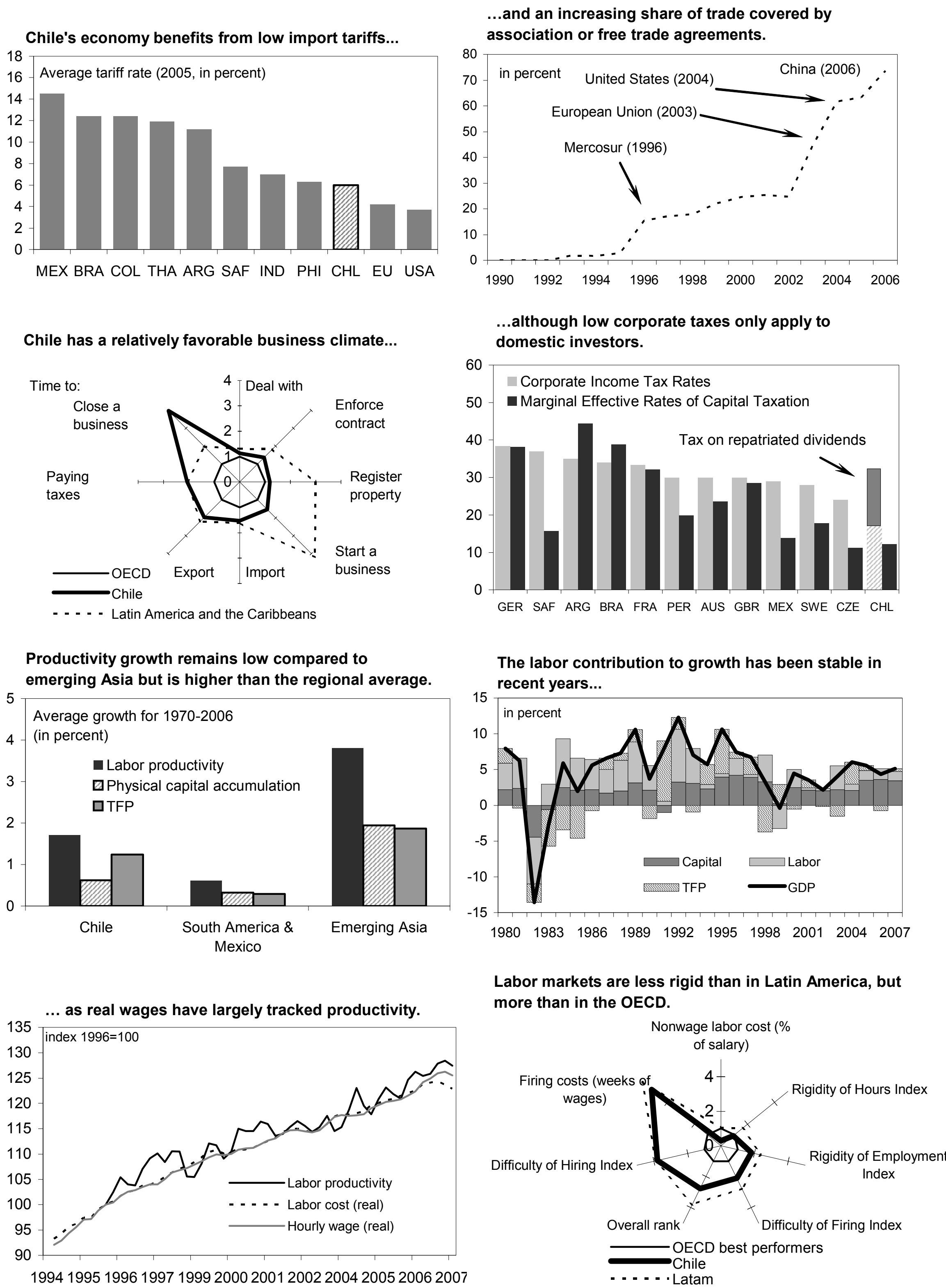


The domestic non-financial sector accounts for close to 90 percent of corporate loans.



Source: Fund Staff estimates; Moody's KMV; Chilean Authorities.

Figure 10. Investment Climate: Sunny, Only a Few Clouds



Source: World Trade Organization, KPMG, CD Howe, World Bank Doing Business Data.

Table 1. Chile: Selected Economic Indicators 1/

				Projections					
	2005	2006	2007	2008	2009	2010	2011	2012	2013
				(Annual percentage change, unless otherwise indicated)					
Production and prices									
Real GDP	5.5	4.3	5.1	4.2	4.6	5.5	5.3	5.3	5.0
Total domestic demand	10.4	6.4	7.8	6.4	6.0	6.7	6.5	6.4	6.2
Consumption	7.1	6.4	7.4	5.9	5.9	6.7	6.4	6.3	6.1
Private	7.4	6.5	7.7	6.0	5.7	6.9	6.5	6.3	6.1
Public	5.9	5.9	5.8	5.6	6.5	5.8	5.8	5.9	5.9
Investment	21.7	6.2	9.0	8.0	6.3	6.9	6.8	6.8	6.7
Private fixed	25.5	2.2	10.2	7.1	6.2	7.0	7.0	7.0	7.0
Public	10.8	10.2	25.5	8.3	7.7	7.9	7.3	7.2	6.2
Inventories (contributions to growth)	-0.3	0.8	-0.6	0.2	0.0	0.0	0.0	0.0	0.0
Net exports (contributions to growth)	-4.5	-2.1	-3.0	-2.6	-1.9	-1.9	-1.9	-2.0	-2.1
Exports	1.7	2.1	3.0	2.2	2.5	2.7	2.7	2.6	2.5
Imports	6.2	4.2	6.0	4.8	4.4	4.6	4.6	4.6	4.6
Real GDP (end of period)	4.3	4.8	4.1	4.6	4.7	5.5	5.3	5.3	5.0
Output gap 2/	0.2	0.8	1.0	1.4	1.8	1.1	0.6	0.0	0.0
Consumer prices									
End of period	3.6	2.6	7.8	5.5	3.7	3.0	3.0	3.0	3.0
Average	3.1	3.4	4.4	7.4	4.4	3.3	3.0	3.0	3.0
Unemployment rate (annual average)	9.3	8.0	7.0	...	...	...	...	...	...
Money and credit									
Broad money	11.9	11.4	15.2	...	...	...	...	...	...
Credit to the private sector (end of period)	19.9	17.7	20.8	...	...	...	...	...	...
				(Billions U.S. dollars, unless otherwise indicated)					
Balance of Payments									
Current account	1.4	6.8	7.2	-1.0	-2.8	-3.4	-4.1	-4.8	-5.4
In percent of GDP	1.2	4.7	4.4	-0.6	-1.6	-1.9	-2.2	-2.4	-2.5
Trade Balance	10.8	22.6	23.7	16.3	8.4	1.0	-3.4	-6.9	-7.7
Exports of Goods	41.3	58.5	67.6	66.6	63.0	59.9	60.1	61.7	66.1
Non-Copper Exports	22.3	25.8	30.1	32.5	34.4	36.6	38.8	42.1	45.8
Imports of Goods	30.5	35.9	44.0	50.3	54.6	58.9	63.5	68.6	73.8
Non-Oil Imports	26.9	31.3	39.2	43.9	47.7	51.5	55.5	59.8	64.4
				(Annual percentage change, unless otherwise indicated)					
Non-Copper Exports	25.3	15.7	16.6	8.0	6.0	6.4	5.8	8.5	8.9
Non-Oil Imports	33.2	16.2	25.4	11.8	8.8	7.9	7.7	7.9	7.6
Net FDI inflows (in percent of GDP)	4.1	3.1	6.4	9.0	6.2	5.4	3.5	2.7	3.1
Real effective exchange rate 3/	11.9	-5.2	8.4	...	...	...	...	...	...
Terms of trade	11.1	31.6	1.1	-9.6	-8.8	-9.2	-9.6	-1.5	0.7
				(In percent of GDP)					
Public sector finance									
Central government balance	4.6	7.7	8.8	7.8	5.3	3.7	2.3	1.9	1.1
Gross public debt 4/	34.9	25.7	24.1	21.9	20.9	20.1	19.3	17.4	15.8
Central government	7.3	5.3	4.1	3.3	2.9	2.7	2.5	2.0	1.5
Net public assets	-11.8	0.3	8.2	11.7	14.5	16.2	16.6	15.4	13.5
Excluding public enterprises	-2.5	4.8	11.9	15.4	18.2	19.9	20.4	18.8	16.7
Saving and investment									
Gross domestic investment	22.2	20.5	21.1	22.4	23.6	24.6	25.7	26.0	26.0
Private fixed	19.1	17.4	18.1	19.1	20.2	21.1	22.1	22.4	22.3
Public investment	2.1	2.1	2.4	2.6	2.8	2.9	3.1	3.1	3.2
National saving	23.4	25.2	25.5	21.8	22.1	22.8	23.5	23.7	23.5
Private	15.9	14.6	13.5	10.9	13.7	15.4	17.3	17.7	18.5
Public 5/	7.5	10.6	12.0	11.0	8.6	7.1	5.8	5.3	4.5
External Debt									
Gross external debt	38.0	32.5	32.7	30.4	30.8	29.9	29.0	27.4	25.5
Private	29.9	25.1	20.9	20.7	21.4	20.9	20.5	19.7	18.8
Public	8.1	7.4	11.8	9.7	9.5	9.0	8.6	7.7	6.7

Sources: Central Bank of Chile, Ministry of Finance, Haver Analytics, and Fund staff estimates.

1/ As of June 12, 2008

2/ Defined as potential minus actual output, divided by potential output

3/ End of period; INS definition of the real effective exchange rate. A decline indicates a depreciation of the peso

4/ Gross consolidated debt of the public sector (central bank, non-financial public enterprises, and general government).

5/ Gross saving of the general government sector, including the deficit of the central bank.

Table 2. Chile: Summary Operations of the Central Government

(In percent of GDP)

				Est.	Proj. 1/	
	2004	2005	2006	2007	2008	2009
Overall balance	2.1	4.6	7.7	8.8	7.8	5.3
Non-Mining Balance	-0.9	-0.6	-1.1	0.2	-0.2	-0.4
Total revenue	22.0	23.9	25.9	27.4	27.3	26.0
Taxes	15.6	16.9	17.0	18.8	18.2	17.9
Nonmining	15.6	15.5	13.9	15.0	15.6	15.9
Mining-related	0.0	1.4	3.1	3.8	2.6	2.0
Codelco revenues	3.0	3.7	5.7	4.8	5.4	3.7
Income on assets	0.4	0.3	0.5	1.2	1.4	2.0
Social contributions	1.4	1.4	1.4	1.5	1.3	1.4
Grants	0.1	0.1	0.1	0.1	0.1	0.1
Other	1.5	1.3	1.2	1.1	0.9	0.9
Total expenditure	19.9	19.3	18.2	18.6	19.5	20.6
Consumption	5.7	5.6	5.4	5.6	5.4	5.6
Social benefits	4.9	4.6	4.3	4.1	4.4	4.7
Subsidies and grants	5.2	5.0	4.8	5.0	5.8	6.2
Interest payments	1.0	0.8	0.7	0.6	0.4	0.4
Gross investment	1.8	1.8	1.8	2.1	2.3	2.5
Defense	1.4	1.3	...	...	...	...
Non-defense	0.4	0.5	...	...	...	...
Net capital transfers	1.3	1.3	1.3	1.1	1.2	1.3
Net Assets	-4.1	0.1	7.0	13.7	17.2	20.2
Gross Debt	10.7	7.3	5.3	4.1	3.3	2.9
Peso-denominated Assets	5.7	5.8	5.1	5.5	5.3	5.3
Foreign currency-denominated Assets	0.9	1.5	7.1	12.3	15.2	17.7
Memorandum Items	-5.6	-9.2	-4.5	-3.8	-3.6	-3.7
Nonmining Structural Balance	-1.8	-0.9	-1.5	0.4	0.0	-0.1
Fiscal Impulse 2/	0.7	-0.9	0.6	-1.9	0.4	0.1
Nonmining Structural Primary Balance 3/	-1.1	-0.3	-1.2	-0.4	-1.3	-2.0
Fiscal Impulse 2/	0.7	-0.8	0.9	-0.8	1.0	0.7
Net Assets of the Public Sector	-11.0	-11.8	0.3	8.2	11.7	14.5
Excluding public enterprises 4/	-5.5	-2.5	4.8	11.9	15.4	18.2
Nominal GDP (trillions of pesos)	58.3	66.2	77.6	85.6	93.3	97.4

Sources: Ministry of Finance (DIPRES) and staff estimates.

1/ Based on the 2008 Budget and updated staff estimates.

2/ Change in nonmining structural balance (-) as a share of GDP excluding extractive activities.

3/ Excludes interest payments and income from government assets.

4/ General government and Central Bank only.

Table 3. Chile: Summary Operations of the Public Sector

(In percent of GDP)

				Est.	Proj.	
	2004	2005	2006	2007	2008	2009
Central government						
Balance	2.1	4.6	7.7	8.8	7.8	5.3
Total revenue	22.0	23.9	25.9	27.4	27.3	26.0
of which: intragovernmental receipts	0.8	0.8	0.7	0.7	0.7	0.7
Total expenditures 1/	19.9	19.3	18.2	18.6	19.5	20.6
of which: intragovernmental transfers	0.7	0.8	0.6	0.6	0.6	0.6
Current	16.8	16.1	15.1	15.4	16.0	16.9
Capital	3.1	3.1	3.0	3.2	3.5	3.7
Net Assets	-4.1	0.1	7.0	13.7	17.2	20.2
Municipalities 2/						
Balance	0.0	0.2	0.2	0.0	0.0	0.0
Total revenue	2.7	2.9	2.7	3.0	3.1	3.1
of which: intragovernmental receipts	0.7	0.8	0.6	0.6	0.6	0.6
Total expenditures	2.8	2.8	2.5	3.0	3.0	3.0
of which: intragovernmental transfers	0.8	0.8	0.7	0.7	0.7	0.7
Current	2.4	2.5	2.2	2.6	2.7	2.7
Capital	0.4	0.3	0.3	0.4	0.4	0.4
Central bank						
Balance	-0.6	-0.5	-0.2	-0.1	0.0	0.0
Net operating balance	0.0	0.0	-0.1	0.0	0.0	0.0
Net interest balance 1/	-0.6	-0.4	-0.2	0.0	0.0	0.0
Net Assets	-1.3	-2.6	-2.2	-1.8	-1.8	-2.0
State-owned non-financial enterprises						
Balance	1.0	1.2	4.1	3.9	3.9	4.0
Total revenue	14.1	12.2	18.8	19.3	18.8	18.6
of which: intragovernmental receipts	0.1	0.1	0.2	0.2	0.2	0.2
Total expenditures	13.2	11.1	14.7	15.4	14.9	14.6
of which: intergovernmental transfers	3.7	4.3	6.2	5.3	5.9	4.2
Current	11.4	9.1	13.1	13.7	13.2	12.8
Capital	1.7	2.0	1.6	1.6	1.7	1.8
Net Assets	-5.6	-9.2	-4.5	-3.8	-3.6	-3.7

Sources: Ministry of Finance (DIPRES), Central Bank of Chile, and staff estimates.

1/ Includes the effects of valuation changes (inflation) to the stock of UF debt and accrued interest on Treasury debt.

2/ On a cash basis.Municipalities hold neither sizeable financial assets nor debt

Table 4. Chile: Indicators of External Vulnerability
(In percent; unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	Proj. 2008
Financial indicators								
M3 (percent change)	10.3	6.3	3.7	10.6	11.9	11.4	15.2	…
less pension funds' deposits (annual percentage change)	9.6	3.9	6.2	6.6	10.8	27.9	15.2	…
Private Sector Credit to GDP	65.6	66.9	64.3	65.3	66.9	66.3	73.3	…
90-day central bank promissory note (nominal) interest rate (avg.)	7.2	3.9	2.8	1.8	3.5	4.8	5.2	…
Share of foreign currency deposits in total deposits	6.7	6.3	6.1	5.7	5.5	5.8	5.8	…
Share of foreign currency loans in total credit	13.7	14.5	10.3	10.0	10.0	10.3	10.2	…
External indicators								
Exports, U.S. dollars (annual percentage change)	-4.9	-0.5	19.2	50.1	26.9	41.7	15.7	-1.5
Imports, U.S. dollars (annual percentage change)	-3.9	-3.9	13.6	27.8	33.0	17.7	22.5	14.4
Terms of trade (annual percentage change)	-7.2	3.8	9.7	22.1	11.1	31.6	1.1	-9.6
REER (end of period, percent change)	-10.1	-6.9	13.4	-3.7	11.9	-5.2	8.4	…
Exchange rate (pesos per US$, period average)	635	689	691	610	560	530	522	…
Current account (percent of GDP)	-1.6	-0.9	-1.1	2.2	1.2	4.7	4.4	-0.6
Financial account less reserves accumulation (percent of GDP)	0.7	1.0	0.6	-2.4	0.2	-3.3	-6.3	6.5
Gross official reserves (in US$ billion) 1/	14.4	15.4	15.9	16.0	17.0	19.4	16.9	26.9
Gross official reserves, months of imports of goods and services	8.3	7.8	6.4	5.0	4.6	4.3	3.3	4.8
Gross official reserves to broad money	21.6	23.5	23.6	19.0	16.5	16.1	11.9	…
Gross official reserves to short-term external debt 2/	144.8	134.4	125.4	115.6	111.8	117.0	113.4	171.0
Total external debt (percent of GDP)	56.2	60.2	58.2	45.5	38.0	32.5	32.7	30.4
Of which: external public sector debt	8.9	10.7	12.5	10.3	8.1	7.4	11.8	9.7
Total external debt to exports of goods and services	171.9	179.5	161.1	112.9	92.8	71.8	70.2	70.6
External interest payments to exports of goods and services	7.6	6.4	4.7	3.3	2.9	2.2	1.8	1.5
External amortization payments to exports of goods and services	19.5	27.4	21.6	19.9	14.0	17.3	5.9	5.4
Financial market indicators								
Stock market index (in US$; period average) 3/	590	483	601	832	1105	1278	1776	1857
Sovereign long-term foreign-currency debt rating (end of period)								
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1	A2	A2	...
S&P	A-	A-	A-	A	A	A+	A+	...
Fitch Ratings	A-	A-	A-	A-	A	A	A	...

Sources: Central Bank of Chile, Haver Analytics, WEO, and Fund staff estimates.

1/ Gold valued at end-period market prices.
2/ As measured by the central bank; includes amortization of medium/long-term debt due during the following year, but not trade credits.
3/ Morgan-Stanley Capital International index (Dec/1987=100). 2008 data averaged up to end-March.

Table 5. Chile: Balance of Payments

	2005	2006	2007	Projections 2008	2009	2010	2011	2012	2013
				(In percent of GDP)					
Current account	1.2	4.7	4.4	-0.6	-1.6	-1.9	-2.2	-2.4	-2.5
Trade balance	9.1	15.4	14.4	9.2	4.8	0.6	-1.8	-3.4	-3.5
Exports	34.9	39.9	41.3	37.6	35.9	32.8	31.7	30.5	30.2
Copper	16.0	22.3	22.9	19.3	16.3	12.8	11.3	9.7	9.3
Non-copper	18.9	17.6	18.4	18.3	19.6	20.1	20.5	20.8	20.9
Imports	-25.8	-24.5	-26.9	-28.4	-31.1	-32.3	-33.5	-33.9	-33.7
Net services	-0.5	-0.4	-0.7	-0.7	-1.4	-1.2	-0.9	-0.9	-0.6
Net income	-8.9	-12.6	-11.1	-10.8	-6.8	-3.0	-1.3	0.2	0.1
Net transfers	1.5	2.3	1.8	1.7	1.8	1.8	1.8	1.7	1.6
Financial Account Balance	1.3	-3.5	-5.7	6.0	1.0	1.0	1.3	2.7	2.8
Foreign direct investment (net)	4.1	3.1	6.4	9.0	6.2	5.4	3.5	2.7	3.1
Abroad	-1.8	-2.0	-2.3	-1.5	-2.5	-2.6	-2.5	-2.3	-2.1
In Chile	5.9	5.0	8.8	10.5	8.7	8.0	6.0	5.0	5.2
Portfolio investment (net)	-2.4	-6.9	-9.5	-4.5	-10.8	-10.3	-8.6	-6.3	-6.4
Abroad	-3.6	-7.4	-9.3	-7.0	-12.5	-12.3	-10.5	-8.0	-8.0
In Chile	1.2	0.5	-0.2	2.5	1.7	2.0	1.9	1.7	1.6
Financial Derivatives	-0.1	0.2	0.3	0.0	0.1	0.1	0.1	0.1	0.1
Other Investments	-0.3	0.2	-2.9	1.5	5.5	5.8	6.3	6.2	6.0
Abroad	-2.0	-2.7	-7.0	-5.5	-0.1	0.3	-0.1	-0.3	-0.5
In Chile	1.7	2.9	4.1	7.0	5.6	5.5	6.4	6.5	6.5
Reserves Assets	-1.5	-1.4	1.9	-6.0	0.0	0.0	0.0	0.0	0.0
Errors and Omissions	-1.0	0.1	-0.6	0.6	0.6	0.9	0.9	-0.3	-0.3
Change in official reserves ($ billion, increase -) 1/	-0.9	-2.5	2.5	-10.0	0.0	0.0	0.0	0.0	0.0
Central bank operations with commercial banks	0.0	0.0	0.0	-10.0	0.0	0.0	0.0	0.0	0.0
Other 2/	-0.9	-2.5	2.5	0.0	0.0	0.0	0.0	0.0	0.0
				(In months of imports of goods and services)					
Gross official international reserves 3/	4.6	4.3	3.3	4.8	4.5	4.2	3.9	3.9	3.9
				(Annual change in percent)					
Total export volume	5.0	2.6	7.2	5.6	6.3	6.8	5.3	6.6	5.9
Copper export	-3.8	-2.2	7.2	3.5	3.5	3.5	3.5	3.5	3.5
Agricultural exports	5.8	6.0	5.7	4.5	5.0	5.0	5.0	5.0	5.0
Industrial exports	10.8	5.2	6.6	7.4	7.3	7.0	5.2	7.0	7.0
Total import volume	21.4	11.7	17.2	10.4	9.0	9.1	8.8	8.5	8.2
Terms of trade	11.1	31.6	1.1	-9.6	-8.8	-9.2	-9.6	-1.5	0.7
Total export prices	21.0	38.3	7.8	-12.2	-17.5	-16.4	-7.5	-5.1	0.6
Copper export prices	34.0	76.7	7.0	-12.1	-19.1	-21.2	-11.7	-11.2	0.0
Total import price	9.0	5.3	4.5	5.7	-0.3	-1.0	-0.8	-0.2	-0.3
				(In percent of GDP)					
Total external debt (end of period)	38.0	32.5	32.7	30.4	30.8	29.9	29.0	27.4	25.5
Memorandum items:									
Copper price (LME; U.S. cents per pound) 4/	167	305	324	350	283	223	197	175	175
Volume of copper exports (2004=100)	96	94	101	104	108	112	116	120	124

Sources: Central Bank of Chile, Haver Analytics, and Fund staff estimates.

1/ "Errors and Omissions" from Haver balance the Current and Capital Account.

2/ "Other" variations in reserves largely reflect changes in deposits by commercial banks and the government with the central bank, as well as the repayment of foreign currency bonds, completed in 2006.

3/ Gold at market valuation. End-year stock of reserves in relation to imports of the following year.

4/ Updated staff forecasts.

Table 6. Chile: External Debt and Debt Service

				Est.	Projections	
	2004	2005	2006	2007	2008	2009
	(In billions of U.S. dollars, end of period)					
Total debt outstanding 1/	**43.5**	**44.9**	**47.6**	**53.6**	**53.9**	**54.1**
Of which: external private debt	33.7	35.4	36.8	34.3	36.7	37.5
Of which: external public debt	9.8	9.6	10.8	19.4	17.2	16.6
Medium- and long-term debt	35.7	37.8	38.3	42.8	42.7	42.7
Public sector	9.1	8.7	9.4	18.0	15.9	15.2
Of which: central government	4.7	4.0	4.3	12.8	10.7	10.1
Private sector	26.6	29.1	28.8	24.8	26.8	27.5
Financial sector	3.8	6.0	5.4	5.2	5.3	5.3
Non-financial sector	22.7	23.1	23.4	19.6	21.5	22.2
Short-term debt 1/	7.9	7.1	9.3	10.8	11.2	11.4
Residual maturity basis	13.9	15.2	16.6	14.9	15.7	13.7
Total debt service	**8.9**	**8.2**	**13.0**	**5.9**	**5.2**	**5.5**
Amortization	7.7	6.8	11.5	4.5	4.1	4.5
Interest	1.3	1.4	1.5	1.4	1.1	1.0
	(In percent of GDP)					
Total external debt, end-period 1/	**45.5**	**38.0**	**32.5**	**32.7**	**30.4**	**30.8**
Of which: external private debt	35.2	29.9	25.1	20.9	20.7	21.4
Of which: external public debt	10.3	8.1	7.4	11.8	9.7	9.5
Gross change (in percent)	-12.7	-7.5	-5.5	0.2	-2.3	0.5
Gross change of nominal stock (in percent)	1.0	3.3	5.9	12.7	0.5	0.4
Interest payments on external debt	1.3	1.2	1.0	0.8	0.6	0.5
	(In percent of exports of goods and services)					
Debt-service payments	23.2	17.0	19.5	7.7	6.8	7.5
Of which: interest	3.3	2.9	2.2	1.8	1.5	1.3
Total external debt outstanding 1/	112.9	92.8	71.8	70.2	70.6	74.0
	(In billions of U.S. dollars)					
Memorandum items:						
Gross international reserves	16.0	17.0	19.4	16.9	26.9	26.9
GDP 2/	95.7	118.2	146.4	163.8	177.4	175.5

Sources: Central Bank of Chile, Haver Analytics, and Fund staff estimates.

1/ Original maturity basis; end of period basis.
2/ At current prices and exchange rates.

Table 7. Social and Demographic Indicators

GDP (2007)		**Poverty rate (2006)**	**13.7**
Chilean pesos (billions)	85,599	Indigent	3.2
U.S. dollars (billions)	162	Poor, not indigent	10.5
Per capita (U.S. dollars)	9,798		
Population and Country Information (2006)		**Health**	
Total (in millions)	16.4	Population per physician (2003)	916
Urban population (in percent of total)	87.9	Population per hospital bed (2002)	385
Area (thousand sq. km.)	756.1		
Density (per sq. km)	21.7		
Annual rate of growth, 1997-2007	1.3		
Population characteristics (2005)		**Access to electricity (2003)**	
Life expectancy at birth (years)	78.2	Percent of population	98.9
Crude birth rate (per thousand)	15.7	Urban (2003)	99.7
Crude death rate (per thousand)	5.4	Rural (2003)	74.6
Infant mortality rate (per 1000 births)	8.0		
Mortality rate (ages 1-4, per 1000)	10.0		
Income distribution (2006)		**Access to safe water (2004)**	
Percent of total income received:		Percent of population	95
By richest 10 percent of households	38.6	Urban	100
By poorest 20 percent of households	4.1	Rural	58
Gini coefficient	0.5		
Distribution of labor force, in percent of total (2007)		**Education**	
Agriculture and fishing	11.2	Adult literacy rate (2006)	n.a.
Mining	1.3	Gross enrollment rates, percent of the age group	
Industry	12.4	Primary education (2005)	104
Construction	7.8	Secondary education (2005)	91
Services, Public Utilities, and Trade	67.3	Tertiary education (2005)	48

Sources: Haver Analytics, INE, World Bank, Encuesta CASEN, and staff estimates.

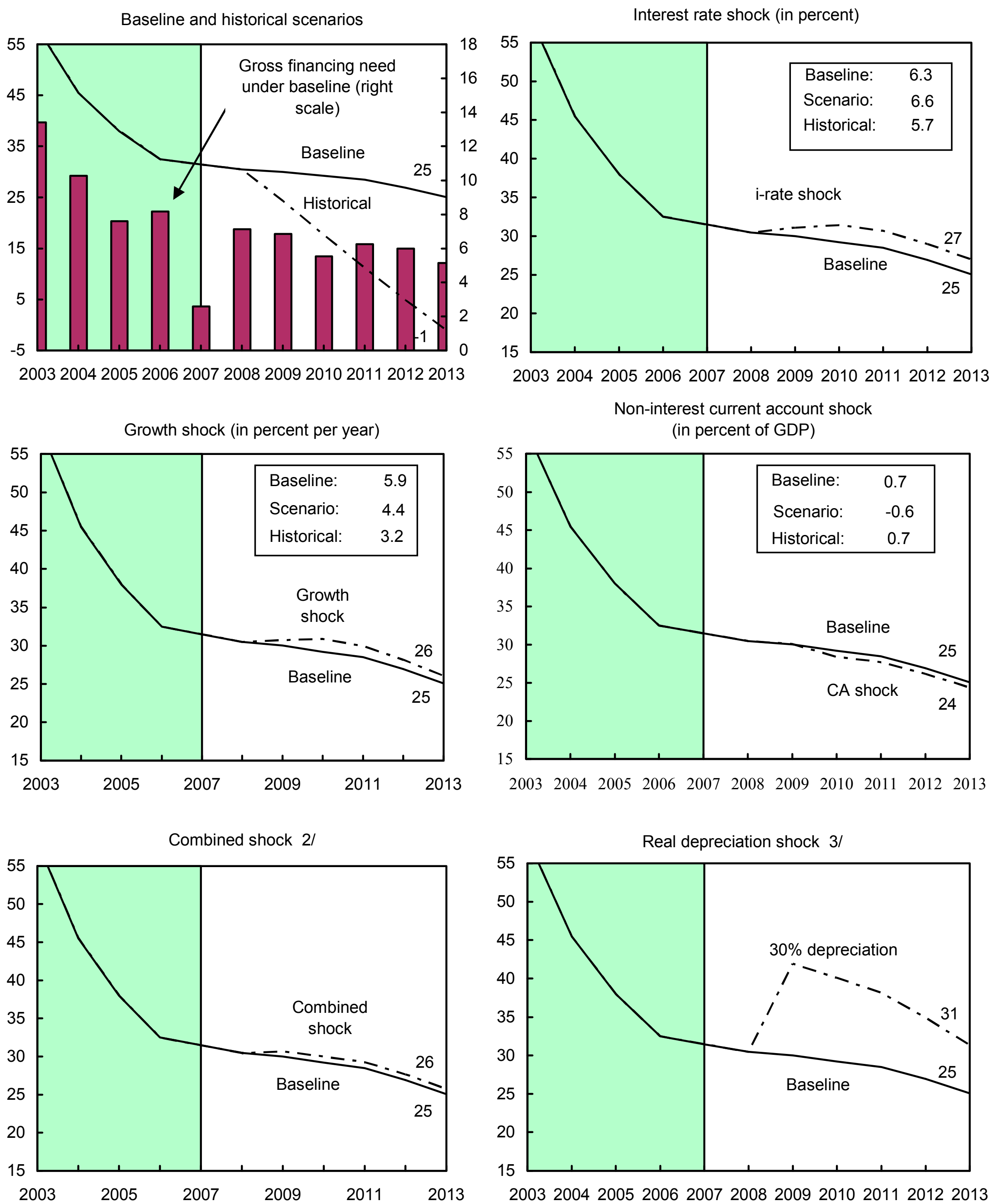
ANNEX 1. CHILE: DEBT SUSTAINABILITY ANALYSIS

The public sector became a net creditor in 2006. Gross public sector debt fell to 9 percent of GDP at end-2007, and public sector assets rose above 10 percent of GDP.

Due to Chile's large public sector assets, the sustainability of public debt is not an issue. The structural surplus rule has restrained expenditure growth during the recent period of high copper prices, and the remaining outstanding external debt largely consists of bonds that cannot easily be prepaid. While the small remaining debt stock is sensitive to some alternative assumptions going forward, additional financing needs stemming from a worse macroeconomic outlook could be covered by the country's Fund for Economic and Social Stabilization, which at end-2008 will hold around 13 percent of GDP.

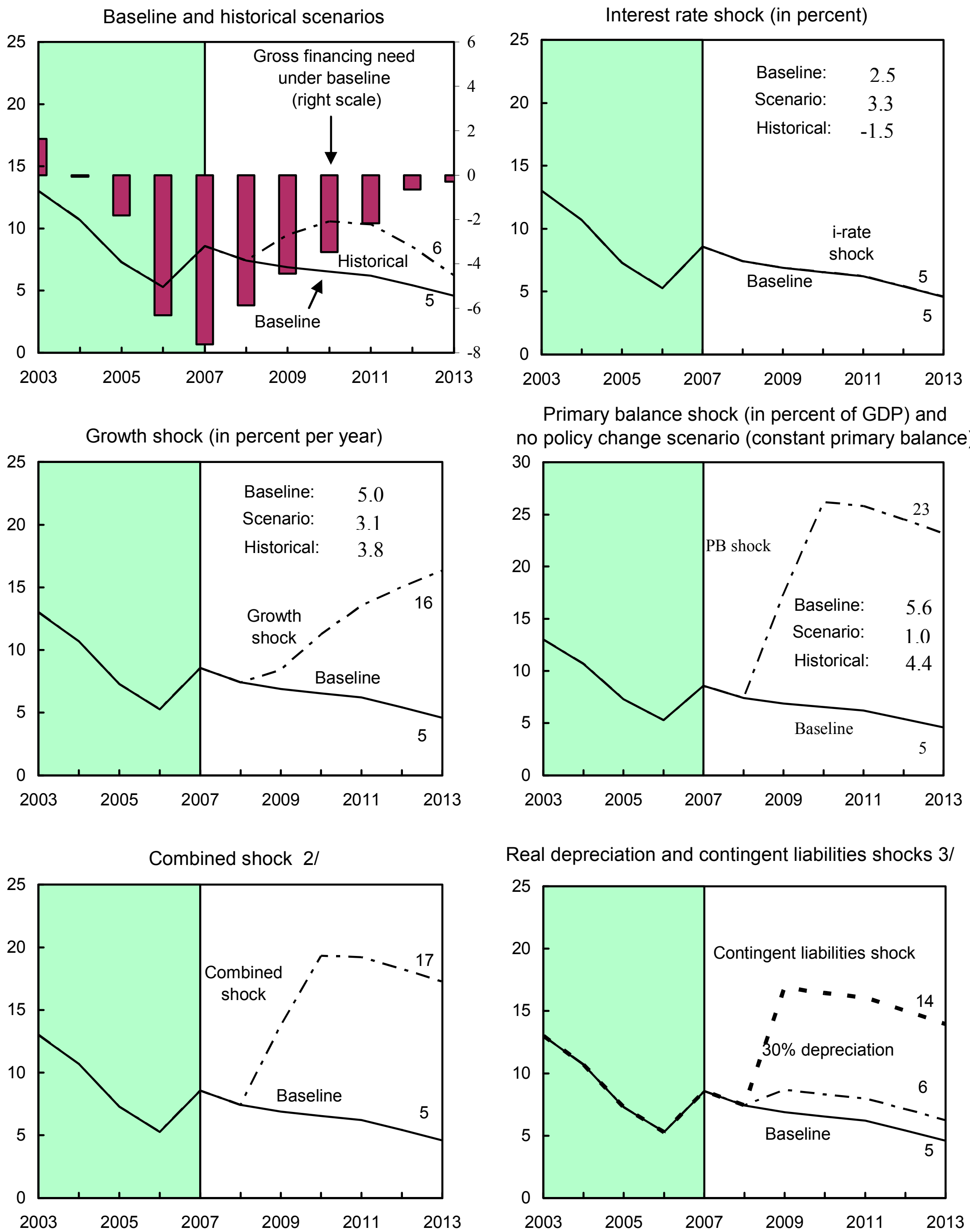
The dynamics of Chile's external debt are stable and less sensitive to shocks. Total external debt fell to 32 percent of GDP in 2007. While the current account is expected to deteriorate over the medium term as copper prices fall, nondebt flows are expected to account for a substantial proportion of necessary financing. Debt levels are not unduly responsive to growth or interest-rate shocks, but are somewhat sensitive to a depreciation, as all of Chile's external debt is denominated in foreign currency.

Figure 1. Chile: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Figure 2. Chile: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table DSA1. Public Sector (Central Government) Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2003	2004	2005	2006	2007			2008	2009	2010	2011	2012	2013	
										I. Baseline Projections				Debt-stabilizing primary balance 12/
Public sector debt 1/	13.0	10.7	7.3	5.3	8.6			**7.4**	**6.9**	**6.5**	**6.2**	**5.4**	**4.6**	**-0.1**
o/w foreign-currency denominated	11.8	9.0	5.2	3.6	5.5			4.5	4.1	3.9	3.6	3.0	2.4	
Change in public sector debt	-2.7	-2.3	-3.4	-2.0	3.3			-1.2	-0.5	-0.3	-0.3	-0.8	-0.8	
Identified debt-creating flows (4+7+12)	-5.5	-6.3	-8.6	-10.5	-11.9			-9.4	-7.3	-6.2	-4.8	-3.7	-3.2	
Primary deficit	-2.4	-4.4	-7.1	-10.0	-11.4			-8.9	-7.3	-6.1	-4.8	-3.6	-3.0	
Revenue and grants	22.8	23.9	26.0	27.8	29.8			27.9	26.6	26.0	25.3	24.1	23.5	
Primary (noninterest) expenditure	20.5	19.5	18.9	17.8	18.4			19.0	19.3	19.9	20.5	20.6	20.4	
Automatic debt dynamics 2/	-3.1	-1.9	-1.6	-0.6	-0.5			-0.5	-0.1	-0.1	-0.1	-0.2	-0.1	
Contribution from interest rate/growth differential 3/	-1.0	-1.2	-0.9	-0.7	-0.2			-0.5	-0.1	-0.1	-0.1	-0.2	-0.1	
Of which contribution from real interest rate	-0.4	-0.5	-0.4	-0.5	0.0			-0.1	0.3	0.3	0.3	0.1	0.1	
Of which contribution from real GDP growth	-0.6	-0.7	-0.5	-0.3	-0.2			-0.4	-0.3	-0.4	-0.3	-0.3	-0.2	
Contribution from exchange rate depreciation 4/	-2.2	-0.7	-0.7	0.2	-0.2			...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.8	4.0	5.2	8.5	15.2			8.2	6.8	5.8	4.5	2.9	2.4	
Public sector debt-to-revenue ratio 1/	56.9	44.7	28.0	19.0	28.8			26.6	25.9	25.2	24.5	22.4	19.5	
Gross financing need 6/	1.6	-0.1	-1.8	-6.3	-7.6			-5.9	-4.4	-3.5	-2.2	-0.7	-0.3	
in billions of U.S. dollars	1.2	-0.1	-2.1	-9.2	-12.5			-10.0	-7.7	-6.2	-4.1	-1.3	-0.6	
						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Key Macroeconomic and Fiscal Assumptions														
Real GDP growth (in percent)	4.0	6.0	5.5	4.3	5.1	3.8	2.0	4.5	4.5	5.5	5.3	5.3	5.0	5.0
Average nominal interest rate on public debt (in percent) 7/	3.7	3.8	4.1	5.2	5.7	4.0	0.8	2.6	2.7	3.1	3.7	4.4	5.7	3.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-2.5	-3.7	-3.5	-7.2	0.8	-1.5	2.7	-1.2	3.6	3.9	4.3	2.1	2.3	2.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	18.8	7.1	8.9	-3.8	7.8	-0.7	10.5	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.2	7.5	7.6	12.4	4.9	5.5	3.1	3.8	-0.9	-0.8	-0.6	2.3	3.4	1.2
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.8	0.9	2.3	-1.5	8.2	3.4	4.1	8.0	6.3	8.8	8.6	5.6	4.2	6.9
Primary deficit	-2.4	-4.4	-7.1	-10.0	-11.4	-4.4	3.8	-8.9	-7.3	-6.1	-4.8	-3.6	-3.0	-5.6
										II. Stress Tests for Public Debt Ratio				Debt-stabilizing primary balance 12/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-10 8/								**7.4**	**9.5**	**10.6**	**10.3**	**8.5**	**6.2**	**-0.3**
A2. No policy change (constant primary balance) in 2005-10								**7.4**	**5.2**	**2.1**	**-2.4**	**-8.3**	**-14.7**	**0.4**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**7.4**	**6.9**	**6.6**	**6.2**	**5.4**	**4.6**	**-0.1**
B2. Real GDP growth is at historical average minus one standard deviations in 2005 and 2006 10/								**7.4**	**8.4**	**11.2**	**13.5**	**15.0**	**16.3**	**-0.4**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**7.4**	**17.4**	**26.2**	**25.8**	**24.5**	**23.2**	**-0.6**
B4. Combination of B1-B3 using one standard deviation shocks								**7.4**	**13.8**	**19.3**	**19.2**	**18.3**	**17.3**	**-0.5**
B5. One time 30 percent real depreciation in 2005 11/								**7.4**	**8.7**	**8.3**	**8.0**	**7.1**	**6.3**	**-0.2**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**7.4**	**16.9**	**16.4**	**16.1**	**15.0**	**13.9**	**-0.4**

1/ Gross debt of the central government. The forecast for the debt stock implicitly includes the effect of the redemption of recognition bonds (amortizations amount to around 1¼ percent of GDP annually in the forecast horizon). The recognition bonds are converted to debt, if the fiscal surplus is not large enough to cover the entire financing needs for the year.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ The implied change in other key variables under this scenario is discussed in the text.

10/ The two-standard deviation estimate is from 1996-2004, because of the exceptional growth rate in 1995 (10 percent) distorts the results.

11/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

12/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 2. External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2003	2004	2005	2006	2007			2008	2009	2010	2011	2012	2013	
										I. Baseline Projections				Debt-stabilizing non-interest current account 7/
External debt	58.2	45.5	38.0	32.5	31.5			**30.5**	**30.0**	**29.2**	**28.5**	**26.9**	**25.1**	**-8.7**
Change in external debt	-2.0	-12.7	-7.5	-5.5	-1.0			-1.0	-0.5	-0.8	-0.7	-1.6	-1.9	
Identified external debt-creating flows (4+8+9)	-9.8	-17.7	-13.8	-16.1	-13.0			-7.6	-6.1	-5.6	-5.4	-5.1	-5.1	
Current account deficit, excluding interest payments	-0.7	-3.5	-2.3	-4.6	-4.5			-0.1	0.8	1.7	2.4	2.9	2.9	
Deficit in balance of goods and services	-4.2	-9.2	-8.6	-14.5	-13.9			-9.8	-4.7	-0.1	4.5	6.1	6.7	
Exports	36.1	40.3	40.9	44.8	46.7			45.8	43.5	40.8	38.1	37.5	37.1	
Imports	31.9	31.1	32.3	30.3	32.9			36.0	38.8	40.7	42.6	43.7	43.8	
Net non-debt creating capital inflows (negative)	-5.4	-2.3	-4.0	-5.2	-5.8			-6.8	-6.1	-6.1	-6.6	-6.8	-6.8	
Automatic debt dynamics 1/	-3.8	-11.8	-7.5	-6.3	-2.6			-0.7	-0.8	-1.2	-1.2	-1.2	-1.1	
Contribution from nominal interest rate	1.7	1.3	1.2	1.0	0.8			0.7	0.5	0.4	0.3	0.2	0.1	
Contribution from real GDP growth	-2.2	-2.7	-2.0	-1.3	-1.5			-1.4	-1.3	-1.6	-1.5	-1.4	-1.2	
Contribution from price and exchange rate changes 2/	-3.3	-10.5	-6.7	-6.0	-2.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	7.8	5.0	6.3	10.6	11.9			6.6	5.6	4.8	4.7	3.6	3.2	
External debt-to-exports ratio (in percent)	161.1	112.9	93.0	72.5	67.4			66.5	68.9	71.6	74.7	71.7	67.6	
Gross external financing need (in billions of US dollars) 4/	9.9	9.8	9.0	12.0	4.2			12.1	11.9	9.9	11.7	11.9	11.1	
in percent of GDP	13.4	10.3	7.6	8.2	2.6	8-Year Historical Average	8-Year Standard Deviation	7.1	6.9	5.5	6.2	6.0	5.1	Projected Average
Key Macroeconomic Assumptions														
Nominal GDP (US dollars)	74.0	95.7	118.2	146.4	163.8			170.0	173.6	180.0	186.7	199.1	216.3	
Real GDP growth (in percent)	4.0	6.0	5.5	4.3	5.1	4.4	1.2	4.5	4.5	5.5	5.3	5.3	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-0.4	13.4	8.9	5.6	1.5	0.1	9.4	-4.3	-1.4	-0.9	-0.9	-0.9	0.0	-1.4
GDP deflator (change in domestic currency)	6.2	7.5	7.6	12.4	4.9	6.4	2.9	3.8	-0.9	-0.8	-0.6	2.3	3.4	1.2
GDP deflator in US dollars (change in percent)	5.8	21.9	17.1	18.7	6.5	6.6	12.0	-0.7	-2.3	-1.7	-1.5	1.3	3.4	-0.2
Nominal external interest rate (in percent)	3.1	3.0	3.3	3.2	2.9	3.6	0.9	2.2	1.8	1.5	1.2	0.9	0.6	1.4
Growth of exports (US dollar terms, in percent)	18.5	44.2	25.3	35.8	16.6	18.5	16.4	1.7	-3.0	-2.7	-3.1	5.0	7.2	0.9
Growth of imports (US dollar terms, in percent)	13.2	25.8	28.4	16.2	21.4	-14.1	81.3	13.6	10.2	8.7	8.5	9.3	8.9	9.9
Current account balance, excluding interest payments	0.7	3.5	2.3	4.6	4.5	2.4	1.6	0.1	-0.8	-1.7	-2.4	-2.9	-2.9	-1.7
Net non-debt creating capital inflows	5.4	2.3	4.0	5.2	5.8	6.2	3.3	6.8	6.1	6.1	6.6	6.8	6.8	6.5
										II. Stress Tests for External Debt Ratio				Debt-stabilizing non-interest current account 7/
A. Alternative Scenario														
A1. Key variables are at their historical averages in 2005-09 5/								30.5	24.3	17.6	11.2	4.8	-1.0	-6.2
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								30.5	31.1	31.4	30.7	29.0	27.0	-8.8
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								30.5	30.7	30.9	30.0	28.1	26.0	-9.2
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								30.5	35.4	40.3	38.3	35.0	31.5	-12.0
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								30.5	30.1	28.4	27.7	26.2	24.4	-8.6
B5. Combination of B1-B4 using one standard deviation shocks								30.5	30.7	30.0	29.3	27.6	25.7	-9.5
B6. One time 30 percent nominal depreciation in 2005								30.5	41.9	40.1	38.2	34.9	31.3	-11.9

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ The implied change in other key variables under this scenario is discussed in the text.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

CHILE

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Western Hemisphere Department

June 18, 2008

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Appendixes

APPENDIX I. CHILE: FUND RELATIONS
(As of April 30, 2008)

I. Membership Status: Joined December 31, 1945; Article VIII. Chile maintains a floating exchange rate system free of restrictions on the making of payments and transfers for current international transactions.

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	856.10	100.00
Fund holdings of currency	802.09	93.69
Reserve Position	54.01	6.31
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	121.92	100.00
Holdings	38.23	31.36

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov 08, 1989	Nov 07, 1990	64.00	64.00
EFF	Aug 15, 1985	Aug 14, 1989	825.00	806.25
Stand-By	Jan 10, 1983	Jan 09, 1985	500.00	500.00

VI. Projected Payments to Fund (in SDR Million)

	2008	2009	2010	2011	2012
Principal					
Charges/Interest	1.75	2.30	2.30	2.30	2.30
Total	1.75	2.30	2.30	2.30	2.30

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

APPENDIX II. CHILE: STATISTICAL ISSUES

Economic and financial data are timely, of good quality, and adequate for surveillance purposes. Chile is in observance with the Special Data Dissemination Standards (SDDS).

Monetary statistics

Monetary and financial statistics are broadly in line with the Fund's Monetary and Financial Statistics Manual (MFSM). Deviations from the guidelines of the *MFSM* include treatment of nonbank financial intermediaries as part of the private sector, and the use of accounting valuation criteria, which are not always in line with measurements at market prices. Nevertheless, for purposes of expressing in local currency, assets and liabilities in foreign currency and indexed units of account, the accounting criterion is consistent, in general terms, with the *MFSM*. Due to a change in the chart of accounts for other depository corporations (ODCs) at the beginning of 2008, the central bank has not been receiving data from the Superintendency of Banks in a format adequate to complete the compilation of monetary statistics. The latest available data for ODCs correspond to December 2007. Efforts to solve the problem are underway, and it is expected that by mid-2008 periodicity and timeliness of the ODC survey will again comply with SDDS requirements.

Real sector

The central bank carried out a project for changing the benchmark and base year of the national accounts to 2003. Annual and quarterly GDP series for 1986–2003 were released in 2007. An STA mission that prepared the Report on the Observance of Standards and Codes for Chile in April-May 2007 found that the legal and institutional frameworks for compiling macroeconomic statistics are generally adequate, but the independence of the National Statistics Institute (INE) needs to be reinforced. Also, there are no legal precepts empowering the central bank to require private non financial institutions to respond to data requests, except for information on foreign exchange transactions.

A much improved business register has been available since 2006. However, updates of INE's business register are partial and conducted on an irregular basis. The household budget survey (HBS) is conducted every 10 years, instead of every five years. The data available for agriculture, fishing, some services, and quarterly estimates are limited in scope. Nonetheless, income tax and VAT records are used to fill in the gaps. Source data reasonably approximate national accounts' requirements and their coverage is satisfactory, although the timeliness of the INE's source data could be further improved.

Chile's national accounts are well established. There is some room for improvement with respect to the treatment of mineral exploration; agricultural work in progress; own-account production of computer software, databases, and manufacturing products; classification of copper derivatives; the functions of government, and individual consumption by purpose.

Coverage of price and labor market statistics should be widened. For the CPI, expanding the survey sample outside Santiago and updating the weights to the 2006-2007 HBS would considerably improve the index. INE compiles a producer price index that contributed to the improvement of national accounts estimates at constant 2003 prices. On labor market statistics, INE introduced a new household survey in 2006, modeled on the U.S. BLS surveys and in line with standards set by the International Labor Organization. The labor market survey of business establishments could benefit from a similar overhaul.

Government finances

Following agreements reached with the Fund in 2002, the authorities have made substantial progress in implementing the *GFSM 2001*. The authorities have developed a statement of central government operations with consolidation of extrabudgetary central government units, and the reclassification of budgetary revenue and spending. A new functional classification of total outlays for the central government aligned with international standards has been disseminated. In addition, separate sets of accounts were compiled for municipalities and for public corporations. A detailed description of the methodologies, institutional tables on coverage, and data for the entire public sector were made available in the October 2004 publication *Estadísticas de las Finanzas Públicas 1987-2003*.

Following FAD recommendations, the Ministry of Finance increased the publication of statistical data beginning with its *October 2004 Public Finance Report*. The report now includes debt liabilities and financial assets of the central government, contingent liabilities (especially government guarantees and concessions), and tax expenditures. In 2006, the government began to publish a report of investments of its assets.

Progress in fiscal accounts is ongoing. The authorities expect to produce estimates for the consumption of fixed capital, and apply accrual and cash accounting using the System of Information for the Financial Management of the Public Sector. This will permit the compilation of opening and closing balance sheets covering the central government, municipalities and public corporations.

However, further improvements are needed. The most urgent are: disaggregating subsidies and grants by level of government; disseminating more detailed data on functional outlays by the level of government; disseminating data on military debt; and reconciling the recording of interest across liabilities, especially with regard to dollar-denominated bonds versus dollar-indexed bonds.

Balance of payments and external debt

The central bank compiles balance of payments and external debt statistics on a quarterly basis, and publishes selected statistics on the external sector on a weekly basis. Beginning in 2002, the central bank has been publishing the International Investment Position consistent with the *fifth edition of the Balance of Payments* Manual (*BPM5*).

The coverage of the military sector in the external statistics is incomplete. In particular, the accuracy of data on military imports needs to be verified, as imports that do not go through customs are estimated by the central bank. Also, if the military receives external credits, information on this may not be available to the central bank; therefore, such financing may not appear in the balance of payments or external debt statistics. Published data on military expenditure are outdated.

Chile: Table of Common Indicators Required for Surveillance
As of June 9, 2008

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo items[7]: Data Quality – Methodological Soundness[8]	Memo items[7]: Data Quality Accuracy and reliability[9]
Exchange Rates	June 4	June 5, 2008	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 23, 2008	June 2, 2008	W	W	W		
Reserve/Base Money	April 2008	May 23, 2008	M	M	M	O, O, LO, O	O, O, O, LO, O
Broad Money	April 2008	May 23, 2008	M	M	M		
Central Bank Balance Sheet	April 2008	May 23, 2008	M	M	M		
Consolidated Balance Sheet of the Banking System	April 2008	May 23, 2008	M	M	M		
Interest Rates[2]	June 4,2008	June 5, 2008	D	D	D		
Consumer Price Index	May 2008	June 5, 2008	M	M	M	LO, LNO, LNO, LO	LO, LO, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2008	April 30, 2008	Q	Q	Q	O, LO, LNO, LO	LO, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing3– Central Government	April 2008	May 30, 2008	M	M	M		
Stocks of Central Government and Central Government – Guaranteed Debt[5]	March 2008	March 31, 2008	A	Q	Q		
External Current Account Balance	May 23, 2008	June 2, 2008	W	W	W	O, O, LO, LO	O, O, O, O, O
Exports and Imports of Goods and Services	May 23, 2008	June 2, 2008	W	W	W		
GDP/GNP	Q1 2008	May 23, 2008	Q	Q	Q	O, LO, LO, LO	LO, LO, LO, LO, O
Gross External Debt	March 2008	May 7, 2008	M	M	M		
International Investment position[10]	Q1 2008	May 23, 2008	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC, (published on June 10, 2005 and based on the findings of the mission that took place during October 14–28, 2004) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.
[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.
10 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

APPENDIX III. CHILE: WORLD BANK –FUND COUNTRY-LEVEL WORK PROGRAM UNDER JMAP

Title	Products	Provisional timing of Missions	Expected delivery date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	**A. CAS, CAS PR** None		
	B. DPL 1. Chile Institutional Strengthening of the Ministry of Public Works DPL (P100854) (TTL: Tomas S. Serebrisky)		Approved 2007
	C. ESW 1. Chile Higher Education Report (with OECD) (P106874) (TTL: Michael F. Crawford)		August 2008
	2. Chile Regional Development Study (P103331) (TTL: Fernando Rojas)		December 2007
	D. Lending (Including Technical Assistance Loans) 1. Chile Technical Assistance Loan for the Ministry of Public Works (P102931) (TTL: Tomas S. Serebrisky)		Approved 2007
	2. Chile Infrastructure for Territorial Development (P076807) (TTL: Nicolas Peltier-Thiberge)		Approved 2004
	3. Chile Lifelong Learning and Training Proj (Chile Califica) (P068271) (TTL: Michael F. Crawford)		Approved 2002
	4. Chile Solidario: Technical Assistance (P08203) (TTL: Theresa Jones)		Approved 2003
	5. Chile Santiago Urban Transport (Transantiago): Technical Assistance		Approved 2005

	(P082412) (TTL: Mr Jorge M. Rebelo)		
	6. Chile Tertiary Education Financing for Results APL1 (P088498) (TTL: Michael F. Crawford)		Approved 2005
	7. Chile - Second Public Expenditure Management (SIGFE II) (P103441) (TTL: Roberto O. Panzardi)		Approved 2007
	E. Fee-Based Service Activity (Technical Assistance)		
	1. Chile Financial Sector Reform and Strengthening Initiative (FIRST): Advisory Services (TTL: Mario Guadamillas) *Strengthening the regulation and supervision in the areas of pension, securities and insurance supervision.*		June 2008
	2. Chile Management of Financial Assets (with the World Bank Treasury) (TA-P106653) (TTL: Roberto Panzardi) *The objective of the advisory services is to support the MoF in assessing the existing institutional capacity and designing a strategic plan to strengthen its investment and debt management operations in line with international best practice.*		Original December 2007 – end date being extended
	3. Chile Management Enhancement Program (TA-P106231) (TTL: Fernando Rojas) *Impact evaluation of Chile's management enhancement program 2001-2006.*		May 2008 April 2008
	4. Chile Credit Reporting System (TA-P107663) (TTL: Mario Guadamillas) *Assessment of credit reporting systems.*		December 2007
	5. Chile Governance of National Innovation System (TA-P107052) (TTL: Esperanza Lasagabaster) *Preparation of a study on the*		mid-2008

	institutional and governance structure of Chile's support system for Science, Technology, and Innovation (STI).		
IMF work program in next 12 months	***Technical Assistance*** 1. Strategic Asset Allocation for SFWs ***Staff Visit*** ***Article IV Consultation***	 3rd quarter of 2008 December 2008 April 2009	 3rd quarter of 2008 July 2009
B. Requests for work program inputs (as needed)			
Fund request to Bank (with summary justification)	None		
Bank request to Fund (with summary justification)	None		
C. Agreement on joint products and missions (as needed)			
Joint products in next 12 months	None		

Statement by the IMF Staff Representative
July 11, 2008

1. ***This statement reports on economic and policy developments in Chile since the Staff Report was issued on June 19***. The thrust of the staff appraisal remains unchanged.

2. ***Recent data are consistent with staff forecasts of below-trend growth in 2008***. Year-on-year growth of economic activity slowed to 2.1 percent in May, and the unemployment rate rose from 7½ to 7¾ percent. On the other hand, the outlook for copper prices has improved in recent weeks, implying a slight upside risk to staff forecasts for the fiscal and current account surpluses.

3. ***Inflation remains high***. The consumer price index rose by 9½ percent in the year to May, and the index excluding food and energy items by 8¾ percent. One-year-forward inflation expectations have risen above 5 percent, and both market and survey-based longer-term expectations have moved into the upper range of the central bank's 2–4 percent comfort zone. On July 2, Governor De Gregorio stated that the return of inflation to target could take longer than initially projected by the central bank, but that the bank would take all necessary measures to ensure convergence over the two-year policy horizon. Staff will provide an oral update on the outcome of the July 10 Monetary Policy Meeting.

4. ***The peso has depreciated markedly over the past few weeks, returning to a level broadly consistent with underlying fundamentals***. Amid rising oil prices and slowing growth, the peso has lost about 7 percent against the U.S. dollar since the Staff Report was finalized (18 percent since its April high), and also fell vis-à-vis the euro and most regional currencies. Updated staff calculations show that—in real effective terms—the peso is now close to its equilibrium value, matching the CGER's "about zero" assessment.

5. ***The central bank has continued its purchases of US$50 million in daily auctions since late April***. Governor De Gregorio recently noted that risks for emerging market economies emanating from adverse global financial developments—the key factor leading to the bank's decision to increase holdings of international reserves—remain in place.

6. ***Congress approved the injection of US$1 billion into the government's fuel stabilization fund***. The first of two equal tranches has already been transferred and will help smooth the impact of higher oil prices on inflation over the next few months, including on consumer products such as heating oil and liquefied gas. The government committed to a review of the fuel tax structure and plans to request Fund technical assistance on this issue.

7. ***The government on June 18, 2008 increased the minimum wage by 10.4 percent***. In real terms, the increase is likely to be close to the increase in the average wage over the past few years. Changes in the minimum wage are not considered to have a large impact on inflation. Nominal growth in salaries has continued to keep pace with actual inflation.

Statement by Javier Silva-Ruete, Executive Director for Chile
Alvaro Rojas, Senior Advisor to Executive Director
July 11, 2008

1. Our authorities would like to thank the staff for a comprehensive and useful Staff Report and Selected Issues papers, which reflect the permanent collaborative dialogue that has characterized the relationship between Chile and the Fund. This year's report corresponds to a fully-fledged Article IV Consultation, after a streamlined version in 2007. As such, this year's report was produced taking into account the 2007 Decision, as it explicitly incorporates an assessment of external stability and the real exchange rate and the policy options for achieving and maintaining external and domestic stability in light of the confluence of domestic and external shocks that have recently impacted the Chilean economy. Given these shocks, Chile's rules-based policy framework has provided enough flexibility in order to respond to them, thereby mitigating their impact in order to ensure domestic and external stability.

Outlook and Risks

2. In 2007, Chile's output grew 5.1 percent, broadly in line with potential output and above the 4.3 percent growth of 2006. This result reflected the still favorable external environment, a more expansionary fiscal policy, and an overall supportive monetary policy. Growth was more dynamic in the communications, construction, and retail sectors, in contrast with the electricity, gas, and water sectors which contracted, given the lesser availability of hydrological resources coupled with ongoing restrictions in the imports of natural gas and higher prices of oil. Such an idiosyncratic shock to the domestic energy generation sector forced a shift towards energy generation using other sources, such as diesel, in a context of unprecedented increases in the price of oil which resulted in energy prices substantially increasing and directly affecting industrial activity. Reflecting this change in the environment, growth weakened significantly during the second half of 2007. Domestic demand grew 7.8 percent, mostly because of the continued consumption dynamism, sustained by still favorable credit conditions and a solid labor market. Investment remained dynamic, relative to previous years, mainly in the mining and energy sectors.

3. The Banco Central de Chile's (BCC) output growth forecast for 2008 was recently decreased by half a percentage point to a range between 4 to 5 percent, with the balance of risks tilted to the downside. Such a downward review is due to a less favorable external environment stemming from the slowdown in the world economy, the ongoing financial crisis, and the uncertainties associated with it; a slower domestic demand due to a less dynamic consumption in a context of lower real income, less favorable credit conditions, and potentially weaker conditions in labor markets. The main downside risks are related to how the credit crisis in financial markets would impact emerging economies, which include the possibility of a protracted slowdown in the U.S., the persistence of uncertainties in

commodity prices, particularly in terms of oil, the possibility of a large correction in the price of copper, and less favorable global financial conditions overall.

4. During the second half of 2007, inflation exhibited a significant acceleration, as CPI inflation reached 7.8 percent year-on-year in December 2007, well above the upper limit of the 3 ± 1 percent target. During the first six months of 2008, annual CPI inflation continued to rise, reaching 9.5 percent in June 2008. Such an increase in inflation resulted from exogenous supply shocks, including a jump in global food prices along with a drought affecting the prices of domestic food items, both of which have proved to be deeper and more persistent than initially anticipated, as well as increases in energy costs and disruptions in energy supply. In line with these developments, core inflation measures and other inflation trend indicators have also remained above the 3 percent target level. The nominal wages growth rate has been in line with traditional indexation clauses while real wage growth has decelerated, showing that second-round effects have been for now relatively contained and in line with historical patterns. From January to mid-April 2008, the Chilean Peso (CLP) appreciated significantly, in part reflecting the weakness of the U.S. dollar, as well as the improved price of copper and the increased interest rate differential with the U.S., due to the aggressive interest rate cuts that the Federal Reserve has conducted in 2008. However, since mid-April, the peso depreciated to a level similar to that of December 2007, a process that can only be partially associated with the intervention policy of the BCC.

5. CPI inflation is expected to remain above the upper limit of the target range during 2008, due to high oil prices and further increases in domestic food prices. Fiscal measures to reduce the impact of high oil prices on the domestic gasoline prices have helped to somewhat mitigate the risk of an excessive additional propagation of supply shocks to underlying price pressures. CPI inflation is expected to gradually move down toward the target range in the first half of 2009, converging to 3 percent by 2010. In line with these developments and in order to ensure inflation convergence to 3 percent in the policy horizon, the Central Bank has already raised the monetary policy interest rate by 175 basis points since mid-2007, bringing it to 6.75 percent in June 2008. The Central Bank's Board stands ready to act in order to fulfill its commitment to price stability by further reducing the monetary impulse in order to avoid an undesired postponement of convergence of inflation to the target, given current inflation risks.

Exchange Rate Valuation and External Stability

6. In terms of Chile's exchange rate valuation, the Staff Report indicates that at the time of the assessment the CLP was currently valued at a level in line with fundamentals or slightly overvalued. Our authorities concur with this assessment. After appreciating markedly during the first three and a half months of 2008, the peso has again reached levels similar to the ones observed by the end of last year. The main reasons behind such temporary misalignment were external as well as domestic. Among the external factors, the generalized weakening of the USD, due to global imbalances which coupled with persistent

high copper prices and an aggressive loosening of monetary policy in the U.S., coincided with an increase in the monetary policy rate, and the expectation of further monetary tightening by market participants earlier this year. Such developments impacted the CLP directly, so that in the first quarter of 2008, the CLP was one of the fastest appreciating currencies against the USD, accumulating a 12.2 percent nominal appreciation, reaching a high of CLP 429 in mid-March of 2008. At such a level, the CEGR analysis of April 2008 found the peso to be overvalued in real effective terms.

7. On April 10, the BCC announced a reserves purchase program of USD 8 billion from April to December 2008 to increase its foreign exchange liquidity in order to be better equipped to confront a worsening and uncertain international scenario. This measure was consistent with the assessment that the strength of the peso at the time, relative to its long term fundamental value, provided a financially sound opportunity for the intervention. The purchase of reserves constitutes an investment in stability, as it would strengthen the international reserves position of the BCC as the provider of foreign exchange liquidity when needed. As indicated in the Staff Report, the reserves purchase program was implemented transparently under pre-announced daily purchases of USD 50 million through competitive bids with no target level for the exchange rate. As of July 8, 2008 a total of USD 3 billion have been purchased with an average bid to cover ratio of 2.28. Given the pre-announced nature of the reserves purchases, the program does not constrain the implementation of monetary policy and it also avoids discretionary use of exchange rate policy for disinflationary purposes. The Technical Note II of the Selected Issues papers provides evidence that supports the authorities' decision to increase the level of reserves to around 15 percent of GDP by end 2008.

8. At the same time, the Ministry of Finance has implemented several measures in order to relieve pressure from the CLP. Given the currency mismatch on the government's balance sheet, which stems from a large surplus position in foreign currency, the government allowed exporters to pay their income taxes directly in USD for the first time in April 2008 and, as of June 2008, they will also be able to pay other taxes in USD, while at the same time allowing companies to have their accounting be done directly in USD. In early May 2008, the Ministry of Finance announced the issuance of an additional USD 800 million in domestic bonds in local currency, which will be used to recapitalize the BCC in USD, so the purchase of the USD equivalent amount would provide additional relief to the pressure on the CLP, which is in line with the reserves purchase program of the BCC described above.

Monetary Policy

9. In line with the acceleration in inflation since mid-2007 through the direct impact of the food and energy components given the high weight they have in the CPI, as well as due to idiosyncratic supply shocks, as clearly presented in Box 1 of the Staff Report and in the Technical Note I of the Selected Issues Papers, and in order to address the potential impact on inflation expectations and second round effects, the BCC initiated a monetary policy

tightening cycle by raising the monetary policy interest rate by 125 basis points between mid-2007 and January 2008, bringing it to 6.25 percent. The BCC paused the interest rates hikes between February and May 2008, thanks to a lack of further inflationary surprises over the first quarter and in order to assess the impact of the interest rate increases of previous months. Consistent with these developments, the inflation outlook contained in the 2008 May Monetary Policy Report was broadly in line with the forecasts of the January Monetary Policy Report. Further monetary policy decisions where in any case made conditional on the impact of incoming data on the inflation outlook over the two-year policy horizon.

10. Given the developments in the price of oil and the fact that inflation of food products proved to be more persistent that initially anticipated, the short-term prospects for inflation deteriorated markedly after May and inflationary expectations shifter higher. In light of the worsening inflation outlook, and in order to ensure inflation convergence to 3 percent in the policy horizon, the BCC raised the monetary policy interest rates by an additional 50 basis points in its Monetary Policy Meeting in June 2008, bringing it to 6.75 percent in order to avoid an undesired postponement of convergence of inflation to the target given current inflationary risks. The Staff Report indicates that further monetary tightening may be needed if further upside risks to inflation were to materialize. The BCC stands ready to act further in order to fulfill its commitment to price stability, as clearly indicated in the statement of the Monetary Policy Meeting in June 2008.

Fiscal Policy

11. The implementation of the structural budget rule and continuing high copper prices determined that in 2007 the Chilean government posted an overall surplus of 8.8 percent of GDP. In the same period, revenues increased 12.1 percent in real terms, while public expenditure grew 8.3 percent. For 2008, the fiscal surplus is expected to reach 4.8 percent of GDP and, as of the first quarter of 2008, the government has already achieved a surplus of 3 percent of GDP. In order to prudently manage windfall revenues and in consistence with the Fiscal Responsibility Law, the Chilean government has continued saving the surpluses into the Economic and Social Stabilization Fund and into the Pension Reserve Fund. At the same time, the Fiscal Responsibility Law allows the government to use its surplus to recapitalize the Central Bank and a payment of USD 900 million is expected to be made during 2008, of which USD 800 million will be financed by the issuance of domestic bonds, as mentioned above. The 2008 Budget constitutes the first budget constructed under the new structural surplus target of ½ percent of GDP and it prioritizes social spending in health, education, innovation, and social housing. At the same time, it focuses on the execution and quality of public expenditure, as noted in the Staff Report.

12. In light of the ongoing increases in oil prices in international markets, the government has undertaken several measures to alleviate its impact on inflation and the overall level of economic activity. Thus, in January 2008 the government submitted a bill to Congress destined to provide an additional injection of USD 200 million to the Fuel Prices

Stabilization Fund (FPSF). In March 2008, the government sent another bill to Congress to reduce the excise tax on gasoline by 25 percent for the next 2 years, until March 2010. Congress approved both measures and gasoline and consumer prices reduced significantly in relation to observed prices at the end of 2007. In June 2008, the government sent a bill to Congress to inject an additional USD 1 billion to the FPSF, as well as USD 250 million in new capital to ENAP, the public refining company. The purpose of these new resources is to provide an ample basis for the stabilization of domestic prices of not only gasoline, but also other fuels, such as those that have a high impact on the population, i.e., heating oil and liquefied gas, in a context of additional increases in the price of oil. These measures should reduce the inflationary impact of potential further increases in the price of oil and other fuels in the short run.

Sovereign Wealth Funds and Macroeconomic Policy

13. Our authorities would like to thank the staff for very useful discussions regarding Chile's Sovereign Wealth Funds (SWFs). The Fund is currently providing technical assistance to Chile to assess the macrofinancial linkages of the management of Chile's SWFs. In addition, a good review of the institutional background is provided in the Selected Issues Paper, the international best practices, and how Chile compares to them, and some preliminary suggestions going forward for the Pension Reserve Fund (PRF) and the Fund for Economic and Social Stabilization (FESS). Even though Chile's SWFs are relatively new compared to other SWFs, our authorities have a firm commitment to manage the resources accumulated in these Funds according to the international best-practice, and in that spirit, in response to an offer by the Minister of Finance, the meeting of the International Working Group of Sovereign Wealth Funds will be held in Santiago in September 2008. In terms of management of the Funds, the Financial Advisory Committee recommended a new Strategic Asset Allocation (SAA) which expands the current SAA comprised of sovereign and agencies bonds (66 percent), money market securities and deposits (30 percent) and indexed bonds (4 percent) to a more broad based portfolio in terms of asset classes, by incorporating corporate bonds (20 percent) and stocks (15 percent), and currencies. The management of this new asset classes will be outsourced to external managers by the end of 2008.

14. Given the size of the resources accumulated in these Funds, returns stemming from the investment of the Funds constitute an important new source of fiscal structural income that is a new feature in terms of fiscal policy. During 2007, the returns from the FESS amounted to USD 933 million (0.6 percent of GDP and 2.1 percent of total revenues) which correspond to structural income. In terms of the real exchange rate, the establishment of the SWFs to save abroad the windfall revenues of the government from the copper price boom has also helped significantly in avoiding the loss of competitiveness that would have otherwise prevailed. As such, Chile's SWFs remain instrumental in preventing the possibility of Dutch disease in light of the large positive terms of trade shock from commodities prices.

15. During the annual address to Congress in May 2008, President Bachelet announced the establishment of a USD 6 billion Fund named the Bicentennial Fund after Chile's forthcoming bicentennial in 2010, which will be setup to secure a permanent income flow from the investment returns in order to fund the provision of scholarships to study abroad for a total of 30,000 students of professional and technical careers over a 10-year period. This initiative constitutes a major investment in the improvement in human capital of the Chilean labor force with the purpose of significantly improving its productivity over the medium term.

Capital Market Development

16. As indicated in the Staff Report, our authorities have concentrated their efforts in increasing the promotion of foreign investor participation in domestic markets and a new bill (Capital Markets III - MKIII), which aims to foster the use of the CLP as a fully internationally traded currency, increases the depth and liquidity of domestic financial markets, and promotes market access for Small and Medium Enterprises, will be sent to Congress before the end of the year. In 2008, the government will issue bonds in the domestic markets up to USD 2 billion. The purpose of this debt issuance is to provide additional liquidity to the local fixed income markets, as well as to establish benchmark securities to foster the development of the domestic financial market. It is also the first time that a 30-year bond is issued by the Chilean Treasury. In reference to the staff's recommendation of an FSAP Update in 2009, our authorities are currently in the process of analyzing such a possibility, as it would provide a useful means to check progress on the recommendations of the previous FSAP of 2004, as well as a chance to address new issues.

Conclusion

17. In light of the recent confluence of domestic and external shocks in terms of higher energy and food prices, as well as the financial turmoil and its impact on world activity, Chile's rules-based policy framework has provided enough flexibility in terms of monetary and fiscal policy in order to respond to these shocks, thereby mitigating their impact so as to ensure domestic and external stability, even under the possibility of a worsening scenario.