

I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. Chile's GDP grew at an annual average rate of 4.8 per cent in real terms between 2003 and 2008, supported by a strong increase in domestic demand. The rate of growth declined in mid-2008 as a result of the international crisis, and the Chilean economy experienced a contraction at the beginning of 2009. Chile's per capita GDP in 2008 was some US\$10,087, one of the highest in Latin America. The positive economic results achieved during most of the period under review reflect a strong macroeconomic leadership and a level of economic openness and international integration that allowed Chile to benefit from an international environment of growth.

2. However, because it has a small and open economy, Chile has been affected by the global financial crisis, mainly as a result of deterioration in the terms of trade, and by the tightening of overall financial conditions. In order to cope with the crisis, Chile is implementing a combination of counter-cyclical policies, including a large fiscal stimulus package and an aggressive policy of reducing its key interest rate. The authorities believe that Chile is well prepared to tackle the current crisis thanks to its fiscal solvency and a well-regulated and capitalized financial system.

3. Chile maintains an inflation-targeting monetary regime, which enabled it to keep inflation rates low between 2003 and 2007. An increase in external inflationary pressures prompted Chile to tighten its monetary policy between 2007 and the end of 2008 in order to avoid a pass-through of inflation to domestic prices, but it loosened that policy in the early months of 2009 in view of the drop in inflation and the increase in spare capacity resulting from the international economic crisis.

4. One of the pillars of Chile's macroeconomic stability has been the prudent fiscal policy implemented by the Government, which has helped Chile to reduce fluctuations in GDP. Fiscal policy since 2007 has been based on the achievement of a structural surplus. Chile recorded a fiscal surplus between 2004 and 2008. Based on what has been observed during the first quarter of the year, a fiscal deficit attributable to decreased revenue is expected in 2009. The fiscal position has been strengthened by the use of sovereign funds and payment on the public debt, as a result of which the Chilean treasury went from a debtor position to that of a net creditor.

5. Chile's balance-of-payments current account posted a surplus between 2004 and 2007, due mainly to the increase in copper exports. The current account posted a deficit in 2008 due to lower copper prices and increased imports, but in the first quarter of 2009 it again showed a surplus. Chile's exports continue to be based primarily on natural resources, particularly mining and specifically copper, as well as on agricultural products (including forestry and fishing). These products generated some 87 per cent of total merchandise export revenue in 2008. Chile's main trading and investment partners are the European Union and the United States of America, although China's importance as a trading partner has grown during the period under review.

6. During the period under review, Chile experienced a strong inflow of foreign direct investment, exceeding US\$17.4 billion, which mostly benefited the electricity, gas, water, mining, and communications sectors.

(2) MACROECONOMIC TRENDS

(i) Economic structure and trends

7. The Chilean economy experienced dynamic growth during most of the period under review. GDP grew at an average annual rate of 4.8 per cent in real terms between 2003 and 2008 (Table I.1). This rate of growth corresponded roughly to the Latin American average for the period and was slightly above the potential rate of growth of GDP, which the International Monetary Fund (IMF) estimates at 4.5 per cent. As the IMF indicates, the framework for Chile's economic policies, mainly fiscal policy, is geared to the achievement of a structural surplus (see below) and has permitted sustained growth, preventing the economy from overheating and delinking it from the effects of the copper price increase, since most of the mining revenue has been deposited in sovereign funds abroad.¹

8. Chile's per capita GDP rose in 2008 to some US\$10,087, one of the highest in Latin America and far higher than the US\$4,746 recorded in 2003. As a result of rapid economic growth and the policies adopted by the Government, the proportion of the population living below the poverty threshold decreased significantly, to 14 per cent in 2008, the lowest level in Latin America and well below the 21.2 per cent seen in 2000. Income distribution inequality also decreased; the Gini coefficient stood at 52.2 per cent in 2008, below the 57 per cent recorded in 2000.

9. In terms of constant pesos (volumes), the sectoral composition of the Chilean economy did not change much during the period under review, as shown in Table I.1. On the other hand, in terms of current pesos, the sectoral composition has undergone major changes due to the extraordinary growth of mining (see Chapter IV(4)). Up to mid-2008, growth in the agricultural, manufacturing and services sectors was generally positive, although manufacturing's percentage share of GDP decreased slightly (see Chapter IV(5)). The share of services in GDP recovered, reaching 66.9 per cent in 2008, after having been affected by the contraction in electricity production (see Chapter IV(6)).

10. Between 2003 and 2008, the total employed population increased from 5.78 million to 6.63 million. Paid employment represents a large share of job creation during the period. The unemployment rate fell from 10 per cent in 2004 to 7.0 per cent in 2007, then rose to 7.7 per cent in 2008 (Table I.1). Real wages increased 8.5 per cent between 2003 and 2008. Productivity per worker (GDP/employment) grew by 10.1 per cent in real terms between 2003 and 2008.

Table I.1
Structure of the economy, 2003-2009

	2003	2004	2005	2006	2007	2008 ^a	2009 I ^b
Share of GDP (percentage)							
<i>Breakdown by sector (constant 2003 Ch\$ million)</i>							
Agriculture and forestry	3.6	3.7	3.8	3.9	3.7	3.7	
Fishing	1.2	1.4	1.3	1.2	1.2	1.2	
Mining	8.4	8.5	7.7	7.4	7.3	6.7	
Copper mining	7.0	7.0	6.3	6.1	6.0	5.5	
Other mining activities	1.4	1.4	1.4	1.3	1.3	1.2	
Manufacturing industry	16.4	16.6	16.6	16.5	16.3	15.8	
Food, beverages, and tobacco	4.9	4.9	4.9	4.9	4.8	4.8	
Textiles, clothing, and leather	0.8	0.8	0.8	0.8	0.7	0.7	
Wood and furniture	1.1	1.2	1.1	1.1	1.0	1.0	
Paper and printed matter	1.7	1.8	1.7	1.7	1.9	1.9	

¹ International Monetary Fund (IMF) (2008), *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*. IMF Country Report No. 08/240, Washington, D.C., July 2008. Viewed at: <http://www.imf.org/external/pubs/ft/scr/2008/cr08240.pdf>

	2003	2004	2005	2006	2007	2008 ^a	2009 1 ^b
Chemicals, petroleum, rubber, and plastic	4.6	4.6	4.6	4.7	4.4	4.2	
Non-metallic minerals and basic metal industries	1.3	1.4	1.4	1.4	1.4	1.2	
Metal products, machinery and equipment, other	1.9	1.9	2.0	1.9	2.0	2.0	
Services	65.3	64.7	65.3	65.6	65.8	66.9	
Electricity, gas and water	2.9	2.8	2.7	2.8	1.9	1.8	
Construction	6.9	6.7	7.0	7.0	7.0	7.5	
Commerce, restaurants and hotels	9.7	9.8	10.1	10.3	10.4	10.5	
Transport	6.9	6.8	6.9	7.1	7.2	7.3	
Communications	2.3	2.3	2.4	2.4	2.6	2.8	
Financial and business services	15.0	15.2	15.6	15.6	16.3	16.8	
Real estate	5.8	5.6	5.5	5.4	5.4	5.4	
Personal services	11.6	11.3	11.0	10.9	10.9	10.8	
Government	4.3	4.2	4.1	4.1	4.0	4.0	
Minus: Bank imputations	3.4	3.5	3.9	3.9	4.4	4.6	
Plus: Net VAT collected	7.4	7.5	7.7	7.9	8.2	8.4	
Plus: Import duties	1.0	1.2	1.4	1.5	1.9	2.0	
Real rates of growth (percentage)							
Total GDP	..	6.0	5.6	4.6	4.7	3.2	-2.1
<i>Breakdown by sector</i>							
Agriculture and forestry	..	8.3	9.3	6.6	0.4	3.0	9.5
Fishing	..	19.1	0.9	-3.5	5.6	-0.7	5.4
Mining	..	6.1	-3.9	0.7	3.1	-5.0	-6.7
Copper mining	..	5.9	-4.9	0.3	3.5	-5.8	-6.4
Other mining activities	..	7.2	1.2	2.6	1.4	-1.6	-8.1
Manufacturing industry	..	7.0	6.0	3.9	3.1	0.0	-10.3
Services	..	5.1	6.5	5.0	5.0	4.8	27.7
Electricity, gas and water	..	2.8	3.0	7.6	-28.8	-4.0	-1.3
Construction	..	3.2	10.1	4.0	5.4	9.7	-5.9
Commerce, restaurants and hotels	..	7.3	8.5	6.9	6.1	3.8	-4.0
Transport	..	4.4	6.7	7.5	5.8	5.0	5.2
Communications	..	8.9	7.3	5.4	14.7	10.4	-0.7
Financial and business services	..	7.9	8.4	4.5	9.4	6.1	3.9
Real estate	..	2.6	3.3	3.2	3.7	3.9	-0.7
Personal services (education, health and other)	..	3.4	3.3	3.7	4.8	2.1	3.9
Government	..	2.2	3.8	3.3	3.6	2.7	-1.9
Minus: Bank imputations	..	10.7	15.6	6.1	15.8	9.9	2.9
Plus: Net VAT collected	..	8.5	8.1	6.6	8.5	6.3	-1.3
Plus: Import duties	..	24.1	22.0	11.3	33.8	9.0	-2.1
II. Employment							
Rate of unemployment (percentage)	9.5	10.0	9.3	8.0	7.0	7.7	
Real wages/hour index (Jan. 2006=100)	95.04	96.77	98.57	100.50	103.33	103.12	106.39
Population (million)	15.6	15.8	16.3	16.4	16.6	16.8	..

.. Not available due to change in series in 2003.

a Preliminary figures.

b First quarter.

Source: Central Bank of Chile.

11. From the standpoint of domestic spending, the period 2003-2008 was marked by a significant increase in investment and a steady growth of private consumption. The investment rate reached its historic peak during 2008, to stand at 30.2 per cent of GDP in real terms. This increase in investment was mainly attributable to the mining and energy sectors. A slowdown in investment, along with a smaller investment in machinery and equipment, has been recorded since the fourth quarter of 2008. The authorities have noted that this contraction is due to the uncertainty caused by the crisis, which has led companies to make more cautious spending decisions, resulting in the postponement and suspension of investment projects.

12. A steady growth of domestic demand was seen throughout this period, mainly because of rapid growth in gross fixed capital formation, but also because of the strong performance of household consumption. The growth of domestic demand declined in mid-2008 as a result of the international crisis, which had an impact on export revenue, increased the cost of external borrowing,

and worsened the expectations of economic operators. The upward trend in domestic demand was also affected by the delayed effect of the adoption of a tight monetary policy in 2007 and 2008, during the time of economic boom, when an international crisis was not yet foreseen. At the beginning of 2009, the Chilean economy experienced contraction, fuelled by a sharp decrease in investment and durable goods consumption and by the extremely deleterious effect of a change in inventories. Among the chiefly cyclical factors that contributed to this outcome are the aforementioned tighter monetary policy, the downward adjustment of copper prices, and the spillover effects of the international financial crisis, including the increased cost of borrowing.

13. The shares of both exports and imports of goods and services in GDP increased (Table I.2). In spite of the rapid growth of exports, due mainly to the fact that copper prices increased substantially up to 2008, the contribution of net exports to real GDP was negative during most of the period under review, since the performance of imports was more dynamic than that of exports in real terms. This period saw strong imports of capital goods, consistent with the high investment rate, and, to a lesser extent, an increase in fuels imports. The contribution of net exports to real GDP became positive in the first quarter of 2009, because domestic demand contracted much more sharply than GDP, so that imports of goods and services dropped significantly more than exports.

Table I.2
Evolution and structure of GDP by type of expenditure, 2003-2009

	2003	2004	2005	2006	2007	2008	2009 I ^a
I. Gross domestic product (GDP)							
GDP at current prices (Ch\$ billion)	51.156,4	58.303,2	66.192,6	77.830,6	85.621,1	88.535,2	..
GDP at current prices (US\$ million)	73,990	95,653	118,250	146,773	163,881	169,458	..
GDP at constant prices (2003, Ch\$ billion)	51.156,4	54.246,8	57.262,6	59.891,0	62.694,1	64.677,0	15.738,6
GDP per capita (current US\$)	4,746	6,064	7,255	8,950	9,872	10,087	..
II. Real GDP and its components (rates of growth) (%)							
Real GDP	..	6.0	5.6	4.6	4.7	3.2	-2.1
Domestic demand	..	7.5	10.4	6.8	7.8	7.4	-7.6
Gross fixed capital formation	..	10.0	23.9	2.3	12.0	19.5	-9.3
Construction and other works	..	3.4	10.7	3.0	7.4	10.5	-3.5
Machinery and equipment	..	22.8	45.3	1.5	17.8	29.8	-15.8
Total consumption	..	7.0	7.1	7.0	7.1	4.2	-0.6
Individual consumption	..	7.2	7.4	7.1	6.9	4.3	-1.4
Government consumption	..	6.1	5.9	6.4	8.0	4.0	3.9
Exports of goods and services	..	13.3	4.3	5.1	7.6	3.1	-2.7
Exports of goods	..	15.7	3.8	4.1	7.1	1.6	-3.0
Exports of services	..	3.9	6.5	9.4	9.6	9.3	-1.5
Imports of goods and services	..	18.4	17.2	10.6	14.9	12.9	-14.8
Imports of goods	..	21.4	19.8	11.6	16.4	15.3	-16.3
Imports of services	..	6.4	5.0	5.2	6.9	-1.8	-5.3
III. GDP at constant prices, percentage composition (%)							
Domestic demand	95.9	97.2	101.6	103.7	106.8	111.2	99.6
Gross fixed capital formation	20.1	20.9	24.5	24.0	25.7	29.7	24.8
Construction and other works	13.3	12.4	12.7	12.0	12.5	14.7	13.9
Machinery and equipment	6.9	8.0	11.0	10.6	12.0	15.1	10.9
Total consumption	74.8	75.5	76.6	78.4	80.2	81.0	78.6
Individual consumption	62.8	63.5	64.6	66.1	67.5	68.2	66.7
Government consumption	12.0	12.0	12.1	12.3	12.6	12.8	11.8
Changes in inventories	1.0	0.8	0.5	1.4	1.0	0.5	-3.8
Exports of goods and services	36.5	39.0	38.6	38.8	39.8	39.8	41.8
Exports of goods	29.2	31.8	31.3	31.2	31.9	31.4	33.6
Exports of services	7.3	7.2	7.3	7.6	7.9	8.4	8.2
Imports of goods and services	32.4	36.2	40.2	42.5	46.6	51.0	41.4
Imports of goods	26.0	29.8	33.8	36.1	40.1	44.8	35.1
Imports of services	6.4	6.4	6.4	6.4	6.6	6.3	6.3
IV. Other economic indicators (% GDP)							
Gross national savings	20.0	22.2	23.4	24.9	25.1	22.2 ^c	..
Foreign savings	1.1	-2.1	1.2	-4.9	-4.5	2.4 ^c	..

Note The calculation methodology was modified as of 2003.

.. Not available.

a First quarter.

Source: Central Bank of Chile.

14. Chile's gross domestic savings rate was 22 per cent in 2008; foreign savings, which had been negative between 2005 and 2007, became positive, contributing to a gross domestic savings rate of 24.6 per cent in 2008.

(ii) Fiscal policy

15. The responsibility for formulating and implementing fiscal policy rests with the Ministry of Finance. Chile's fiscal policy during the period under review continued to be geared towards maintaining structural surpluses and provident funds which can serve as future cushions in the event of potential fiscal imbalances.

16. The policy of attaining a structural surplus, applied since 2000, is aimed at medium-term fiscal stability, while permitting counter-cyclical measures in periods of slower economic growth.² Initially, this surplus was 1 per cent of GDP, but was reduced to 0.5 per cent of GDP in 2008. A recent IMF study underscores the appropriateness of this reduction in view of the economic cycle.³ Given the adverse international environment, the Government decided to set the structural surplus at 0.0 per cent of GDP in 2009, which, according to the authorities, has left room for implementing an active counter-cyclical policy.⁴

17. Chile recorded a fiscal surplus between 2004 and 2008 (Table I.3). This reflected a substantial increase in revenue, particularly tax revenue, as well as control of spending. The revenue increase was partly the result of a favourable international environment, with high copper prices and rapid growth rates. High operating surpluses, which reached their peak in 2007, were seen throughout this period. The fiscal surplus has narrowed since the last quarter of 2008 owing to the change in international circumstances, but the structural surplus target was met in 2008. In that year, tax revenue fell by 8.2 per cent in real terms, while spending increased by 6.7 per cent. Reflecting the economic situation, central government finances showed a slight deficit in the first quarter of 2009. The authorities believe that this deficit follows the logic of the structural surplus rule, which provides for higher spending in periods of lower economic activity, thus stimulating the economy.

Table I.3
Central Government finances, 2003-2009
(As a percentage of GDP)

	2003	2004	2005	2006	2007	2008	2009 I ^a
I. Revenue	20.7	22.0	23.8	25.8	27.5	26.1	5.1
Net tax revenue	15.9	15.6	16.9	17.0	18.9	18.4	4.0
Unwrought copper	0.8	3.0	3.7	5.7	4.8	3.6	0.1
Estimated taxes	1.4	1.4	1.4	1.4	1.3	1.4	0.4
Grants	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Income from assets	0.6	0.4	0.3	0.5	1.2	1.3	0.2
Operating revenue	0.8	0.7	0.6	0.6	0.5	0.6	0.2
Other revenue	1.0	0.8	0.7	0.6	0.7	0.7	0.2
II. Expenditure	17.9	16.8	16.1	15.1	15.4	17.1	4.8
Personnel	4.2	3.9	3.8	3.6	3.6	4.0	1.2
Consumer and producer goods and services	1.6	1.7	1.8	1.8	1.9	1.9	0.5
Interest	1.1	1.0	0.8	0.7	0.6	0.5	0.2
Subsidies and grants	5.5	5.2	5.0	4.8	5.0	6.1	1.6

² The structural balance differs from the effective balance in that it separates the cyclical component of fiscal accounts from the balance, in an effort to show, for each year, what the net result of the fiscal accounts would have been if the economy had followed its medium-term path in that year.

³ IMF (2009), *Chile's Structural Fiscal Surplus Rule: A Model-Based Evaluation*. Prepared by Michael Kumhof and Douglas Laxton, IMF Working Paper, WP/09/88, Research Department. Viewed at: <http://www.imf.org/external/pubs/ft/wp/2009/wp0988.pdf>

⁴ The Ministry of Finance provides information on spending decisions in the framework of the surplus policy at: <http://www.hacienda.gov.cl/ministerio/presupuesto.php>

	2003	2004	2005	2006	2007	2008	2009 I ^a
Estimated benefits	5.3	4.9	4.6	4.3	4.2	4.5	1.2
Other	0.2	0.1	0.0	0.0	0.0	0.2	0.1
Gross operating balance	2.8	5.2	7.7	10.7	12.0	9.0	0.3
Net acquisition of non-financial assets	3.2	3.1	3.1	3.0	3.2	3.8	1.0
Investment	2.0	1.8	1.8	1.8	2.1	2.3	0.6
Capital transfers	1.3	1.3	1.3	1.3	1.1	1.5	0.5
Total revenue	20.7	22.0	23.8	25.9	27.5	26.1	5.2
Total expenditure	21.2	19.9	19.3	18.2	18.7	20.9	5.9
Net lending/net borrowing	-0.5	2.1	4.6	7.7	8.8	5.2	-0.7
Memo items:							
Total public debt (US\$ million)	11,091.2	11,120.9	9,371.2	7,666.4	7,094.0	7,335.0	n.a.
Internal debt	6,389.4	6,171.9	5,138.5	3,495.2	3,437.9	4,400.0	n.a.
External debt	4,701.9	4,949.0	4,232.7	4,171.2	3,656.2	2,934.9	n.a.
Total public debt as a percentage of GDP	13.0	10.7	7.3	5.3	4.1	5.2	n.a.

n.a. Not available.

a First quarter.

Source: Ministry of Finance.

18. As a result of the consolidation of trade liberalization, fiscal revenue from taxes on foreign trade, excluding VAT, decreased as a percentage of total tax revenue during the period under review, from 3.9 per cent of the total in 2003 to some 1.9 per cent in 2008.

19. Up to 2006, Chile maintained a Copper Stabilization Fund. By means of the Fiscal Accountability Law (Law 20.128 of 2006), Chile modified its policy on management of the savings generated by implementation of the structural balance rule, creating the *Fondo de Reserva de Pensiones* – FRP (Pension Reserve Fund) and the *Fondo de Estabilización Económica y Social* – FEES (Economic and Social Stabilization Fund). The resources of the two funds, which are managed by the Central Bank, are invested abroad, solely in relatively low-risk assets.

20. The FEES, which absorbed the balance of the former Copper Stabilization Fund, makes it possible to finance any fiscal deficits and to amortize the public debt, thereby cushioning the effect on fiscal expenditure of the volatility of revenue from taxes, copper, and other sources.⁵ Each year the FEES receives the positive balance that remains after deducting contributions to the FRP and to the Central Bank of Chile from the actual fiscal surplus, discounting, where appropriate, public debt amortizations and early contributions made in the previous year. The objective of the FRP is to support the financing of fiscal obligations deriving from the State guarantee of basic old age and invalidity social pensions, as well as the estimated social contributions. The FRP increases each year by a minimum amount equivalent to 0.2 per cent of the previous year's GDP. If the actual fiscal surplus is higher than 0.2 per cent of GDP, the FRP receives a contribution equivalent to that surplus, up to a maximum of 0.5 per cent of GDP.⁶

21. From its inception on 6 March 2007 to February 2009, the FEES received contributions totalling US\$18.1 billion. In February 2009 its value was US\$19.334 billion. The financial investments made during that period generated additional resources amounting to US\$1.234 billion.

⁵ The FEES was established in March 2007, with an initial contribution of US\$2.580 billion, of which US\$2.563.7 billion represented the balance of the former Copper Revenue Stabilization Fund. Online information from the Ministry of Finance, viewed at: http://www.hacienda.gov.cl/fondos_soberanos/fondo_de_estabilizacion_economica_y_social.php

⁶ The FRP was established in December 2006, with an initial contribution of US\$604.5 million. Online information from the Ministry of Finance, viewed at: http://www.hacienda.gov.cl/fondos_soberanos/fondo_de_reserva_de_pensiones.php

Since its establishment on 28 December 2006, the FRP has received contributions totalling US\$2.250 billion. Its value as of February 2009 was US\$2.398 billion.

22. The Chilean public debt contracted significantly during the period under review, from US\$11.0912 billion in 2003 (13.0 per cent of GDP) to US\$7.335 billion in 2008 (5.2 per cent of GDP). Between 2003 and 2007, the debt continued on a downward trend; however, it underwent a slight increase in 2008. Chile's public sector has shown a creditor position since 2006 because in that year its assets exceeded the public debt. The policy of using accumulated surpluses to prepay the debt and accumulate external assets is continuing. Chile is one of the few countries in Latin America with an investment-grade public debt. In February 2009, Moody's raised Chile's sovereign risk from A2 to A1, with a positive outlook.

(iii) Monetary and exchange policy

23. The monetary policy of the Central Bank of Chile (BCCh) is aimed primarily at keeping inflation low, stable, and sustainable over time. In order to meet this objective, the BCCh has adopted an inflation-targeting monetary regime characterized by the setting of an explicit numerical inflation target to be achieved over a particular time horizon. Meeting that target takes precedence over any other policy objective. The BCCh implements its monetary policy by identifying a target level for the nominal interbank interest rate, known as the monetary policy rate (MPR). In order to ensure that the interbank rate is at the desired level, the BCCh regulates the liquidity (or reserves) of the financial system, using several instruments: open-market operations, purchase and sale of short-term notes, and credit lines and cash deposits (extended facilities). The BCCh does not use reserve requirements on deposits as an active monetary policy instrument.

24. The Central Bank's explicit objective since 2007 has been to keep the consumer price index (CPI) annual inflation rate at around 3 per cent, with a tolerance range of plus or minus 1 percentage point. This objective must be met within a two-year horizon. The authorities believe that the chief merit of the inflation-targeting regime is that it allows stabilization policies to be carried out by having a strong effect on inflationary expectations. The BCCh believes that gearing monetary policy towards achievement of the inflation target helps to moderate fluctuations in employment and domestic production.⁷ A recent study concluded that the inflation-targeting system has had positive results for Chile by helping to contain inflation at low and sustainable levels, giving monetary policy a high degree of credibility, and helping to contain the increase in long-term nominal interest rates.⁸

25. During the period under review, monetary policy was conducted in three main phases: an accommodative phase between 2003 and 2004; a phase in which an increasingly tighter monetary policy was applied, between 2005 and 2008; and a phase of rapid easing of monetary policy in 2009. In order to counteract the effects of the international financial crisis on the level of activity of the Chilean economy, and having succeeded in bringing down inflation (see below), the BCCh conducted an aggressive easy money policy during the first half of 2009, which has had the effect of bringing down the MPR from 8.25 per cent in December 2008 to 0.75 per cent in May 2009.

26. Market interest rates increased substantially between 2007 and 2008, then fell in 2009. The average spread between interest rates on loans and on deposits has varied between 2.5 per cent and

⁷ Central Bank of Chile (2009), *Monetary Policy Report*, May 2009. Viewed at: <http://www.bcentral.cl/publicaciones/politicas/pdf/ipm052009.pdf>

⁸ Rodrigo Valdés, *Inflation Targeting in Chile: Experience and Selected Issues*, Central Bank of Chile, Economic Policy Documents, No. 22, November 2007. Viewed at: <http://www.bcentral.cl/estudios/documentos-politica-economica/pdf/dpe22.pdf>

8.2 per cent since 2003 (Table I.4). In 2009, despite a substantial decline in lending rates, the spread has remained high.⁹

27. The Central Bank succeeded in keeping inflation rates at low levels between 2003 and 2007, with average inflation levels between 1.1 per cent in 2004 and 4.4 per cent in 2007. However, largely because of the increase in prices of petroleum and other raw materials, inflation began to rise in the second half of 2007 and reached a peak level of 9.9 per cent in October 2008, well above the inflation target that had been set. According to the IMF, the impact of inflation was greater in Chile than in other countries because foodstuffs and fuel represent a larger share of the CPI in Chile (27 and 4 per cent, respectively) than in other countries, and the lack of subsidies means that prices of these goods have a high pass-through effect on domestic prices.¹⁰

Table I.4
Key monetary indicators, 2003-2009
(Percentage)

	2003	2004	2005	2006	2007	2008	2009 ^a
Money and credit supply (12-month rate of change)							
Base money	17.1	4.5	20.2	23.0	13.9	9.5	12.4
Money in circulation	6.5	15.3	15.8	14.1	12.9	12.4	11.2
M1	14.7	20.5	18.1	19.1	18.6	6.7	13.2
M2	24.1	11.9	21.5	11.2	11.4	17.5	18.7
M3	7.6	8.9	2.8	-3.4	12.3	10.6	14.3
Interest rates (end of period)							
Commercial credits, 30-89 days	5.68	5.44	7.99	7.78	9.75	16.47	8.70
Commercial deposits, 30-89 days	2.52	2.76	5.40	5.28	6.48	8.28	1.68
Interest spread between credits and deposits, 30-89 days	3.16	2.68	2.59	2.50	3.27	8.19	7.02
Monetary policy rate	2.25	2.25	4.50	5.25	6.00	8.25	1.25
Inflation							
Consumer price index (average annual)	2.8	1.1	3.1	3.4	4.4	8.7	..
Consumer price index (December-December)	1.1	2.4	3.7	2.6	7.8	7.1	4.5
Exchange rate							
Exchange rate (period average, Ch\$/US\$)	602.9	576.2	514.3	527.6	499.3	649.3	592.9
Multilateral nominal exchange rate	111.4	111.1	97.5	104.1	103.6	126.1	112.2
Real exchange rate (1986=100)	95.4	98.0	86.6	93.4	91.9	107.0	95.3
Real rate change (end of period) ^b	-4.7	2.7	-11.6	7.8	-1.6	16.5	-9.8

Note: The multilateral exchange rate index (MER) represents a measure of the nominal value of the peso against a broad basket of currencies. The observed real exchange rate (OER) is defined as the observed nominal exchange rate multiplied by the quotient between relevant external inflation and the CPI.

a Data to April 2009.

b A negative sign implies a real appreciation.

.. Not applicable.

Source: Central Bank of Chile.

28. In response to higher inflation levels, the BCCh tightened its monetary policy between 2007 and the end of 2008, relaxing it in the early months of 2009. In first few months of 2009, inflation fell rapidly as a result of the slowdown in economic growth, spare capacity, and the drop in prices of commodities, especially petroleum and petroleum products. Thus, the annual change in the PCI fell to 4.5 per cent in April 2009.

⁹ Central Bank of Chile (2009), *Monetary Policy Report*, May 2009. Viewed at: <http://www.bcentral.cl/publicaciones/politicas/pdf/ipm052009.pdf>

¹⁰ IMF (2008), *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*. IMF Country Report No. 08/240, Washington, D.C., July 2008. Viewed at: <http://www.imf.org/external/pubs/ft/scr/2008/cr08240.pdf>

29. Chile maintains a floating exchange rate system. On an exceptional basis, the BCCh may intervene in the exchange market in situations of high volatility and uncertainty, but such interventions must be consistent with the inflation target and the time-frames and amounts involved must also be explicitly defined. The interventions must also be announced in advance and sterilized in order to preserve the independence of monetary policy. The nominal exchange rate appreciated substantially between 2003 and the beginning of 2008, leading to a certain appreciation of the real exchange rate (Table I.4).¹¹ The BCCh intervened in the exchange market between April and September 2008 as part of a policy of building up reserves in order to cushion adverse external scenarios or tight credit situations in international markets.

(iv) Balance of payments

30. Chile's balance-of-payments current account posted a surplus between 2004 and 2007, mainly as a result of increased exports, especially of copper (Table I.5). The surpluses seen in 2006 and 2007 were particularly high, representing 4.9 and 4.4 per cent of GDP, respectively. In 2008, there was a sharp decline in the current account balance, largely because of the drop in copper prices and the rise in imports. In the first quarter of 2009, however, the current account posted a surplus, mainly as a result of a contraction in imports (Table I.5).

31. Between 2005 and 2007, Chile's merchandise trade balance showed a growing surplus, due mainly to the higher value of copper exports as a result of higher international prices for copper. Reflecting the positive growth of GDP and the real appreciation of the peso, merchandise imports grew rapidly, more than tripling between 2003 and 2008. In 2009, however, imports fell, reflecting the contraction in economic activity. Exports tripled between 2003 and 2007, then suffered a contraction in 2008, attributable in part to lower copper prices. The trade balance in services, which has traditionally shown a deficit, posted a surplus in the first quarter of 2009.

Table I.5
Balance of payments, 2003-2009
(US\$ million)

	2003	2004	2005	2006	2007	2008	2009 ^a
I. Current account	-778.7	2,074.5	1,449.0	7,154.3	7,188.6	-3,439.6	639.3
A. Goods and services	3,105.0	8,839.2	10,153.2	22,148.9	22,660.2	8,199.6	2,497.6
Goods	3,722.8	9,585.2	10,774.7	22,780.4	23,635.0	8,845.8	2,351.5
Exports	21,664.2	32,520.4	41,266.9	58,680.1	67,665.7	66,455.5	11,274.2
Imports	-17,941.3	-22,935.1	-30,492.3	-35,899.8	-44,030.7	-57,609.5	-8,922.7
Services	-617.9	-745.8	-621.5	-631.3	-974.9	-646.2	146.1
Credits	5,069.5	6,033.8	7,134.0	7,830.4	8,951.9	10,754.5	2,454.3
Debits	-5,687.5	-6,779.6	-7,755.5	-8,461.9	-9,926.8	-11,400.6	-2,308.1
B. Income	-4,488.6	-7,836.6	-10,487.0	-18,401.0	-18,594.5	-14,562.9	-2,173.6
Remuneration of employees	-3.5	-3.6	-3.2	-3.2	-3.2	-3.2	-0.8
Income from direct investment	-3,959.3	-7,279.7	-10,353.3	-18,772.9	-20,071.4	-15,764.5	-2,255.9
Income from portfolio investment	-367.8	-546.4	-167.2	229.3	1,140.1	1,022.9	158.3
Income from other investment	-158.0	-7.1	36.6	145.7	339.8	181.8	-75.2
C. Current transfers	604.9	1,071.8	1,782.8	3,406.3	3,123.0	2,923.9	315.3
Credits	901.0	1,411.1	2,199.3	4,002.9	3,850.8	3,873.8	508.7
Debits	-296.1	-339.2	-416.2	-596.5	-727.8	-950.0	-193.4

¹¹ In July 2008 the IMF estimated that the peso was undervalued by 0 to 10 per cent. IMF (2008), *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*. IMF Country Report No. 08/240, Washington, D.C., July 2008. Viewed at: <http://www.imf.org/external/pubs/ft/scr/2008/cr08240.pdf>

	2003	2004	2005	2006	2007	2008	2009 ^a
II. Capital and financial account	1,511.1	-1,804.9	-124.8	-6,199.3	-5,767.6	5,565.6	636.8
A. Capital account	0.0	5.1	41.3	13.3	15.7	3.1	0.9
B. Financial account	1,511.1	-1,810.0	-166.1	-6,212.5	-5,783.3	5,562.6	635.9
Direct investment	2,701.1	5,609.5	4,801.1	4,555.9	9,568.2	9,895.6	1,311.5
Abroad (assets)	-1,606.3	-1,563.1	-2,182.7	-2,742.4	-3,009.1	-6,891.2	-2,193.3
In Chile (liabilities)	4,307.5	7,172.7	6,983.8	7,298.4	125,77.2	16,786.8	-3,504.8
Portfolio investment	-2,645.2	-3,308.4	-2,832.9	-9,238.5	-16,578.9	-9,543.4	224.9
Assets	-4,698.9	-4,430.2	-4,227.2	-10,084.7	-16,070.8	-12,629.9	-971.6
Liabilities	2,053.7	1,121.8	1,394.3	846.2	-508.0	3,086.3	1,196.4
Financial derivatives	117.8	-84.0	-62.5	300.8	453.6	324.4	453.5
Other investment	971.8	-4,218.0	-356.0	166.8	-2,440.1	11,330.3	-894.3
Reserve assets	365.6	190.8	-1,715.7	-1,997.5	3,214.1	-6,444.2	459.6
III. Errors and omissions	-732.4	-269.5	-1,324.2	-955.0	-1,421.2	-2,126.0	-1,276.1
Memorandum items:							
Balance-of-payments position	-365.6	-190.8	1,715.7	1,997.5	-3,214.1	6,444.2	459.6
Current account as % of GDP	1.1	2.2	1.2	4.9	4.4	2.0	..
Average copper price (US\$/pound)	0.81	1.30	1.67	3.05	3.23	3.16	2.28

a First quarter.

Source: Central Bank of Chile.

32. Cumulative net inflows of foreign direct investment (FDI) between 2003 and 2008 were some US\$37 billion, reaching a peak level in 2008 of nearly US\$9.9 billion. As a result of the substantial amount of foreign investment in the Chilean economy, remittances of profits have left a revenue balance that is deeply in deficit. Remittances of profits were higher than net FDI flows throughout the period under review.

33. In December 2008, the public external debt stood at US\$2.935 billion, which is roughly equivalent to 5.2 per cent of GDP; in 2003, the gross public external debt was US\$4.702 billion, or some 13 per cent of GDP. The gross private external debt in 2008 stood at some US\$61.5 billion, compared with US\$39.5 billion in 2003.

(3) MERCHANDISE TRADE AND INVESTMENT FLOWS

(i) Composition of trade

34. Chile's exports consist mostly of primary products, including processed mining and agricultural products. Partly as a result of higher copper prices, the share of these primary products in total exports increased during the period under review, from 80.4 per cent in 2003 to 86.8 per cent in 2008. Mining products accounted for more than 62 per cent of Chilean merchandise exports in 2008, in comparison with 41 per cent in 2003 (Table AI.1). Total exports of copper ore and refined copper represented 54 per cent of Chilean exports in 2008, well above the 36.2 per cent seen in 2003. Agricultural products represented 23.3 per cent of Chilean exports in 2008, a smaller proportion than the 37.2 per cent recorded in 2003. Agricultural exports consist mainly of wine, fruit, fish, and agricultural raw materials, in particular forestry products.

35. The nominal value of Chilean imports increased by 225 per cent between 2003 and 2008. The composition of imports also shifted during the period under review, mainly because of the increased share of fuel in total imports, which went from 19.1 per cent in 2003 to 29.7 per cent in 2008. This caused a relative increase in the share of fuel at the expense of other categories (Table AI.2). On the other hand, the share of manufacturing imports decreased, from 69.7 per cent in 2003 to 60.4 per cent in 2008. Within these, the main category continued to be machinery and transport equipment, with 30.4 per cent of imports in 2008, compared with 34.1 per cent in 2003.

(ii) Direction of trade

36. Chile's main export market in 2008 continued to be the European Union, which absorbed 24.4 per cent of its exports, a figure similar to the 24.5 per cent recorded in 2003 (Table AI.3). The share of exports to the United States fell from 17.8 per cent in 2003 to 11.4 per cent in 2008, while Japan's share declined from 12 per cent in 2003 to 10.8 per cent in 2008. The share of other Asian countries in Chile's exports increased from 20.1 per cent in 2003 to 29.4 per cent in 2008, mainly owing to an increase of more than 5 percentage points in exports to China, which accounted for 14.7 per cent. The share of exports to other countries in the Americas remained relatively stable during the period under review, going from 21.6 per cent in 2003 to 21.3 per cent in 2008. Among the major markets, the share of exports to Mexico decreased, while the share of exports to Brazil increased.

37. Chile's largest supplier in 2008 was the United States, with 19.4 per cent of the total, followed by the European Union, China, and Argentina (Table AI.4). While the share of imports from the United States increased substantially between 2003 and 2008, Argentina's share shrank by more than 12 percentage points, to less than 9 per cent in 2008. China's imports increased substantially, from 7.4 per cent of the total in 2003 to 12 per cent in 2008.

38. Trade with countries with which Chile had preferential trade or partial scope agreements in force (as at May 2008) continued to increase during the period under review and represented 90 per cent of exports and 95 per cent of imports in 2008, in comparison with the 49 per cent and 59 per cent, respectively, noted in the previous review.

(iii) Trade in services

39. Chile has a relatively stable deficit balance in trade in services (Table AI.5). The deficit is particularly high for the "Other services" category, which includes professional services, financial services, and insurance.

(iv) Foreign direct investment

40. Chile continued to receive strong foreign investment flows during the period under review; these flows have galvanized economic growth and foreign trade. According to data provided by the Foreign Investment Committee, the accumulated inflow of foreign investment capital between 2003 and 2008 amounted to US\$17,455 billion, of which 29.9 per cent went to the electricity, gas and water sector, 29.3 per cent to the mining sector, and 15 per cent to communications (Table AI.6).

41. The main source countries for investment capital flows into Chile between 2003 and 2008 were Canada (28.6 per cent), Spain (28.1 per cent), the United States (9.7 per cent), and Mexico (6.3 per cent) (Table AI.7).

(4) OUTLOOK

42. The authorities believe that Chile is enmeshed in the most adverse global scenario of the post-war era, and that the terms of trade will worsen by 13.5 per cent in 2009, after falling 15 per cent in 2008. However, the authorities consider that Chile's capacity to mitigate the cycle is substantially greater than during previous episodes, given that the world crisis is being faced with a sound financial system, appropriate regulation, large accumulated external savings, and a fiscal policy based on clear

and stable rules.¹² The Central Bank expects a range of GDP variation between -0.75 per cent and 0.25 per cent for 2009, owing in particular to a sharp contraction in domestic demand of around 4.7 per cent. Exports and imports of goods and services are expected to shrink 1.7 per cent and 10.6 per cent, respectively, and a current account deficit equivalent to 1.8 per cent of GDP is anticipated. Average inflation should drop to 2.3 per cent and then remain fixed at 1.5 per cent in 2010.¹³

43. The IMF on the other hand projects a real GDP growth rate of 0.1 per cent in 2009, which should accelerate to around 3 per cent in 2010. The estimated increase in the CPI is 2.9 per cent for 2009 and 3.5 per cent for 2010.¹⁴

¹² Central Bank of Chile, *Monetary Policy Report*, May 2009, p. 46. Viewed at: <http://www.bcentral.cl/publicaciones/politicas/pdf/ipm052009.pdf>

¹³ Central Bank of Chile (2009), *Monetary Policy Report*, May 2009. Viewed at: <http://www.bcentral.cl/publicaciones/politicas/pdf/ipm052009.pdf>

¹⁴ Online information from the IMF. Viewed at: <http://www.imf.org/external/country/CHL/index.htm>