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some cases to cover debt service and new investments. 1/ Beginning in 1976, the consolidated operating balance of the public enterprises has shown a surplus equivalent to almost 2 percent of GDP, and the overall balance, including investment, has been approximately zero.

244. Enterprise budgets are now expected to yield a net profit, the proceeds of which are transferred to the Treasury. Conceptually, investment resources are allocated not as a function of each enterprise's retained earnings and borrowing power--i.e. as an internal decision of the individual enterprise--but as a consequence of investment priorities established for the public sector as a whole. This includes the copper corporation (CODELCO), which is required to deliver all foreign exchange proceeds to the Central Bank, receiving back only that amount needed to cover centrally budgeted operating costs, investments, and debt service. 2/

245. As in the case of the central government, some of the improvement in the financial situation of the enterprises has come through personnel reductions (see Vol. III, Table 5.22). A large part of the improvement, of course, is attributable to the divestiture of many of the enterprises acquired or intervened by the UP Government. Many, if not most of these enterprises, were operating at substantial losses, and a condition of their return to the original owners was that the latter assume all accumulated debts and waive any damage claims against the government. Finally, the enterprises shared in the general austerity and shortage of foreign exchange, and investment levels were deeply cut. In the case of CODELCO, the mission found that it was failing to invest sums equal to depreciation of existing capital stock.

246. Although the Government has moved rapidly to reduce the role of the State in the economy while shifting increasing responsibility to the private sector for directing the allocation of resources, it is necessary to keep in perspective the enormous continuing importance of the remaining state enterprises. Of Chile's 100 largest nonfinancial enterprises, according to book value, the companies in which the State owns 50 percent or more of the shares at the end of 1976 accounted for 79 percent of total assets and 81 percent of net worth. 3/ The State controls all of the top ten enterprises and 20 of the top 25. By their very size as well as for economic and political reasons, the largest of these enterprises--which include CODELCO, ENDESA, CHILECTRA, CAP, ENAP, and so on--will remain in the public sector within any foreseeable future and thus set a limit to the feasible reduction of the State's direct role in the economy. In short, the State is and will continue to be responsible for a significant fraction of the national

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1/ The state nitrate and coal companies (SOQUIMICH and ENACAR) and the national airline (LAN) continued to receive operating subsidies in 1977. The state railroad received budget support to cover pension payments from its retirement fund and external debt service. The port authority (EMPORCHI), shipping company (EMPREMAR), urban bus company (ETC), and LAN also received transfers to cover debt service.

2/ The operations of CODELCO are discussed further in Chapter IV.

3/ Colocadora Nacional de Valores, Informe Economico, No. 18, September 1977. For a complete listing, see Vol. III, Table 8.25.

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patrimony. The proper management and growth of that patrimony will necessarily continue to require that a considerable fraction of the nation's resources be allocated via the decision-making mechanisms of the public sector.

2. Monetary Policy

247. As discussed in Chapters I and II, monetary policy was for decades virtually nonexistent as an independent tool of macroeconomic policy. Central Bank reserve creation and credit expansion were functions largely of the public sector deficit. Moreover, during the 1971-73 period, control over the deficit progressively deteriorated as government agencies and enterprises skirted the budgetary process and borrowed freely from the Central Bank, either directly or through captive commercial banks. In the initial months after the military assumed control of the government, the precarious financial situation of the banks themselves, as well as the administrative difficulties and confusion arising during their transition back to private ownership, provided a weak institutional base for the control of monetary aggregates. Furthermore, inflationary expectations had by 1973 greatly reduced the public's willingness to hold money balances, rendering monetary policy at best a blunt instrument for influencing the level of aggregate demand.

248. The Government thus faced, in effect, the task of reconstructing the financial system, establishing the Central Bank's control over the monetary aggregates, in coordination with the reforms simultaneously occurring in fiscal management and foreign exchange policies, and facilitating the system's performance in allocating financial resources in a manner consistent with the free market orientation of the new economic strategy. Among the measures taken were:

(1) The progressive raising and ultimate elimination of the legal ceiling on interest rates;

(2) The legalization and exemption from income taxation of monetary correction clauses for all financial obligations with greater than one-year maturities, 1/ later shortened to a daily basis;

(3) The nationalization of the Central Bank, establishment of its policy-making authority over all institutions receiving deposits from the public, and prohibition of its lending to entities other than the central government, commercial banks, and other financial institutions;

(4) The subjection of finance companies and other private financial institutions to the supervisory authority of the Superintendency of Banks, renamed the Superintendency of Banks and Financial Institutions;

1/ Formally, any compensation for loss of purchasing power was legally treated as interest and thus subject to the ceiling. Exceptions were made only for SINAP, BECH, and the Central Bank, each of which operated under its own special legislation.

(5) The strengthening of the Finance Minister's control over virtually all important economic policy variables through creation of a Monetary Council with full responsibility for determining policy in the areas of money, credit, interest rates, debt, capital market activity, foreign exchange, tariffs and other trade matters, and veto power over all loans to the central government;

(6) The issuance by the Treasury and the Central Bank of indexed securities in an effort to dampen monetary expansion and provide noninflationary financing for the fiscal deficit; 1/

(7) The move toward multipurpose financial institutions, via the relaxation of restrictions on the types of operations that the various heretofore highly specialized financial institutions may undertake, in order to increase competition, and take advantage of potential scale economies; 2/

(8) The sale back to the private sector of most of the banking shares acquired by the State during the Allende Government; 3/

(9) The elimination of quantitative credit limits on commercial bank lending operations; and finally,

(10) The progressive elimination of special credit lines from the Central Bank.

249. These structural reforms are intended to establish a competitive financial system in which the allocation of resources is determined by the forces of supply and demand as reflected by the rate of interest. The government retains responsibility for setting and enforcing the overall rules

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1/ After 1976, when the peso fiscal deficit was eliminated, this form of financing was discontinued. The restoration of public confidence has also permitted several of the public enterprises to issue their own securities on the open market, thus avoiding further reliance on budgetary transfers or Central Bank credits. Among the enterprises successfully issuing commercial paper or debentures have been CAP, IANSA and LAN.

2/ Thus commercial banks are now authorized to lend for housing and to open savings and investment departments for other long-term operations and development banks are allowed to finance working capital and mortgages.

3/ The Decree, promulgated in December 1974, prohibited the State from owning commercial bank shares and defined procedures by which existing holdings were to be disposed of by the end of 1977. Subsequent delays, however, and the repossession of one bank already divested because of irregularities in the new management have caused the final date to be extended to 1980.

of the game and for regulating in a nondiscriminatory fashion the total supply of credit in the interest of macroeconomic growth and stability; most specific quantitative and qualitative controls have been eliminated. The reforms undertaken so far have produced a relatively well developed financial structure, although some serious problems still remain. The difficulty of this transformation was magnified by the severe liquidity constraints placed on both the banks and the productive sectors of the economy by the heavy debts and high inflation rates inherited from the past and the severe austerity program and economic recession through which the economy has had simultaneously to pass. Some pieces of the reform, particularly those having to do with the long end of the financial system--i.e., the capital market--remain to be worked out as the authorities were necessarily preoccupied with the policy demands of the short term.

a. Money and Credit

250. The major tools of Chilean monetary policy traditionally were the power to fix the reserve requirement on commercial bank deposits, to set quantitative limits on credit expansion on a bank-by-bank basis, to rediscount commercial bank loans, and to fix interest rates. Years of inflation had virtually destroyed the marketability of government securities, thus precluding the development of open market operations. The remaining tools were largely meaningless so long as the Central Bank was required to finance the deficits of the public sector.

251. As the fiscal deficit has been reduced and the focus of credit has shifted to the private sector, monetary policy has taken on greater significance. Since 1973, quantitative and selective credit controls were progressively relaxed, although the initial maintenance of high reserve requirements kept credit expansion closely tied to the rediscount policy and selective credit lines of the Central Bank. The increasing sales of public debt instruments have served to absorb liquidity, but there still is no effective open market operation, in the sense of a secondary market where the Central Bank could purchase and sell securities in sufficient volume to effect desired changes in the money supply. The monetary authorities do not believe that it would be desirable, at the present time, to use a secondary market for this purpose. Moreover, the bulk of these securities were initially bought by the social security institutions or by commercial banks as part of a mandatory

"technical" reserve requirement, and are thus better viewed as an adjunct to reserve policy. 1/

252. The freeing of prices and the Government's efforts to maintain employment and restore purchasing power led to a rapid expansion of money and credit during the last quarter of 1973, M_1 more than doubling in nominal terms (Table III.17). Velocity evidently declined, however, with the resolution of political uncertainties. Credit to the public sector continued to fuel monetary expansion during 1974 (see Table III.18), but at a significantly reduced rate. Most notable was the lower credit requirement of the public enterprises, as total banking system credit to the public sector outside the central government contracted for the first time since 1970. On the other hand, growth of credit to the private sector was extremely rapid, and overall the net domestic assets of the banking system grew some 85 percent relative to the stock of money and quasi-money existing at the end of 1973. 2/

1/ The major public debt instruments in use are:

1. Discountable Treasury Bills (Pagares Descontables de Tesoreria). Negotiable short-term paper of 35-91 day maturities issued daily. Until May 1976, the rate of discount was determined at auction; since then, the daily rate has been determined immediately prior to sale by the Treasurer on the basis of market conditions.

2. Readjustable Savings Certificates (CARs). Nonnegotiable securities issued by Central Bank, indexed, with maturities of more than one year, and a 7 percent rate of interest.

3. Central Bank Bills (Pagares del Banco Central). Thirty-day renewable paper issued by the Central Bank to financial institutions to hold as part of their technical reserves. Interest rate fixed periodically by the Central Bank.

4. Certificates of Financial Savings (CAFs). Three-month bearer paper issued by the Central Bank with a floating interest rate determined at auction.

5. Certificates of Foreign Exchange Cover (CEPACs). Zero-interest bearer paper issued by Central Bank, denominated in U.S. dollars, with two-year maturity, for application only to imports or other foreign exchange transactions.

2/ The exact percentage change is affected by the choice of exchange rate applied to assets and liabilities. Given the rapid inflation and large exchange rate adjustments occurring during the period, the calculation is necessarily somewhat arbitrary and should be taken only as an order of magnitude. Quarterly calculations are offered for subsequent years, thereby reducing the exchange rate problem, but at the cost of introducing some seasonal distortions resulting, for example, from the periodicity of public debt amortization. Finally, while the percent changes relative to the existing base of liquid financial assets appears very large, account should be taken of the extremely small size to which that base had shrunk in real terms.

Table III.17: CHILE - GROWTH OF MONEY SUPPLY BY QUARTERS, 1973(IV)-1978

(Percent)

Year/Quarter		Current Pesos: Change During Quarter	Current Pesos: Change From Year Earlier	Pesos of December 1969: Change During Quarter	Pesos of December 1969: Change From Year Earlier
1973	(IV)	107.8	419.0	34.9	2.8
1974	(I)	24.1	376.2	-4.4	-15.1
	(II)	23.3	341.7	-18.4	2.4
	(III)	35.1	330.1	-3.2	-18.3
	(IV)	42.9	195.4	2.8	-37.9
1975	(I)	32.9	216.4	-17.4	-32.9
	(II)	23.8	217.7	-26.3	-39.2
	(III)	43.4	237.2	10.1	-30.9
	(IV)	51.3	257.2	20.5	-19.1
1976	(I)	23.9	233.0	-10.3	-12.1
	(II)	21.4	226.6	-12.0	5.8
	(III)	28.2	192.0	3.7	-1.3
	(IV)	50.0	189.4	28.8	5.6
1977	(I)	27.4	197.5	7.2	26.1
	(II)	11.4	173.0	-0.7	42.1
	(III)	15.5	145.8	3.6	42.3
	(IV)	30.2	113.5	18.6	30.8
1978	(I)	22.6	105.4	14.3	39.4
	(II)	1.9	87.9	-4.6	34.0
	(III)	n.a.	n.a.	n.a.	n.a.
	(IV)	n.a.	65.0	n.a.	26.6

Source: Vol. III, Table 6.2

Given the very high commercial bank reserve requirements in effect, the expansion had to be funded primarily by the Central Bank, either directly or indirectly through rediscounts, refinancing, and tolerance of reserve deficiencies. 1/ The nominal money supply grew almost three-fold. Nevertheless, the expansion of money lagged far behind the rate of inflation as

1/ On January 1, 1974, the reserve requirement on demand deposits was raised to 80 percent of the average daily deposit levels of December 1973, plus a marginal requirement equal to 95 percent of increments from that base. On October 1, 1974, the base reserve requirement was raised to 100 percent of the average daily deposits of September with a marginal requirement of 80 percent. The interest rate charged on reserve deficiencies was also increased sharply--to 25 percent--and collected monthly. However, to soften the contractionary effect, the banks were given until March 1975 to complete a phased elimination of their reserve deficits. (The evolution of reserve requirements over time, by financial institution and type of liability, is given in Vol. III, Table 6.7).

Table [illegible]: CHILE - BANKING SYSTEM CREDIT EXPANSION IN RELATION TO SUPPLY OF MONEY AND QUASI-MONEY AT BEGINNING OF PERIOD, 1973(IV) - 1977

(Percent)

Period		Private Sector	PUBLIC SECTOR: Central Govern- ment	Decentral. Agencies a/	Public Enter- prises b/	CODELCO	SINAP	Other c/	Total	Net Domestic Assets d/
1973:	4th Quarter	20.5	16.1	-16.6	23.2	-1.9	-	-	20.8	55.6
1974:	Year	46.0	19.9	- 6.0	4.0	-1.9	e/	f/	16.1	85.1
1975:	1st Quarter g/	6.5	23.9	-10.1	6.2	2.5	3.7	1.0	27.5	25.5
	2nd "	12.4	-4.8	- 3.5	-2.2	-2.6	4.0	1.8	-7.4	12.8
	3rd "	6.9	0.6	- 2.6	-3.6	-1.4	4.4	13.4	10.9	11.9
	4th "	14.3	13.3	- 4.9	-3.9	3.5	4.9	2.4	15.3	32.3
1976:	1st "	7.8	7.6	- 3.7	6.0	1.4	4.2	-0.0	15.5	8.4
	2nd "	13.9	3.0	1.7	2.7	-3.7	6.5	-3.2	7.0	15.4
	3rd "	17.2	1.4	- 3.1	1.8	-0.5	9.2	1.0	9.8	1.3
	4th "	19.5	8.9	- 0.8	-2.5	-2.0	5.7	0.0	9.3	34.5
1977:	1st "	22.3	12.2	- 2.8	-0.2	0.9	12.3	-1.7	20.6	22.1

a/ Includes social security system, and municipalities.
b/ Excluding CODELCO.
c/ Consists primarily of import credits financed from abroad and interest on foreign currency obligations.
d/ Includes also net unclassified assets, interbank float, official capital and surplus, and revaluation accounts.
e/ Included in decentralized agencies.
f/ Included in public enterprises.
g/ In January 1975, the central government assumed substantial outstanding debts of the decentralized agencies and public enterprises to the banking system.

Source: Vol. III, Table 6.1

the demand for real money balances declined. Inflationary expectations, as evidenced by increasing velocity, seemed to worsen as the year progressed. The stock of quasi-money increased slightly less rapidly than M_1, reflecting in part the growing relative attractiveness of alternative financial instruments outside the banking system.

253. With declining copper revenues, the expansion of credit to the public sector accelerated in the last quarter of 1974 and the first quarter of 1975, and the nominal money supply rose 43 percent and 33 percent, respectively, in the two periods. 1/ Another growing source of monetary expansion was the substantial Central Bank financing of withdrawals from the Savings and Loan System (SINAP), as depositors became increasingly concerned about its solvency, and the freeing of interest rates and the extended use of indexing made other financial instruments more attractive.

254. The expansion of credit slowed sharply through the first three quarters of 1975 with the virtual elimination of the public sector deficit. An effort was made to slow the net withdrawal of funds from SINAP by freeing it from interest rate controls on non-indexed deposits and credits of less than one-year maturity 2/ and authorizing it to issue indexed notes of greater than one-year maturity. While some new funds were thus attracted to the System, other measures further reduced the attractiveness of its major existing instrument, the Readjustable Mortgage Security (VHR), and the net withdrawals, financed by Central Bank credits, accelerated. 3/ Meanwhile, the growth of bank credit to the private sector was constrained by higher reserve requirements, and quantitative restrictions on the growth of bank loan portfolios. Other measures introduced in an effort to reduce liquidity included: the freeing of interest charged by commercial banks on local currency loans of less than one year; the extension of reserve requirements to all nonbank financial institutions; increasing the minimum holding period of an interest-bearing asset from four to thirty days; authorizing commercial banks to accept term deposits; and raising the maximum size of State Bank term savings accounts eligible for monetary correction as well as the rate of interest paid on such accounts.

1/ The rapid increase in credit shown to the central government is somewhat deceptive, reflecting in part the assumption of debt obligations of the decentralized agencies and public enterprises.

2/ SINAP had been authorized since October 1974 to engage in short-term operations, but interest rates had been fixed too low to be competitive with the private finance companies.

3/ In an attempt to slow the withdrawal of VHRs from the SINAP, existing holdings were partially frozen in June 1975, each depositor being allowed the option of withdrawing a maximum equivalent to US$100 per month per account or of converting the VHRs into negotiable five-year Readjustable Mortgage Bonds (BHRs). This conversion option was terminated in December 1975 and replaced with the option to convert VHRs into a special issue of Central Bank Readjustable Savings Certificates (CARs) having phased maturities of 1 to 15 years. In retrospect, it appears that the uncertainty and further loss of confidence in SINAP and its savings instruments caused by these measures may have served to accelerate the net outflows from the system.

255. Despite these efforts, the nominal money supply rose by more than 250 percent during 1975. Instead of the public sector deficit, the major source of expansion over the course of the year had become foreign exchange operations resulting from increased capital repatriation and short-term inflows as well as the growth of non-copper exports and depressed imports, all converted at a sharply higher (in pesos terms) rate of exchange. Nevertheless, M_1 again contracted in real terms and had become equivalent to less than 4 percent of the GDP. There was a notable decline in velocity during the second half of the year, as the austerity program was seen to be taking hold and inflation decelerating.

256. An important turning point in monetary policy occurred in 1976. The elimination of the public sector deficit had greatly reduced the latter's credit demands, except for foreign debt service, thereby permitting a significant relaxation of constraints on lending to the private sector. At the same time, the sharp reduction in the rate of inflation was reflected in the decline in inflationary expectations, and the resultant steady increase in the demand for real money balances permitted the authorities to move toward gradual restoration of more normal levels of liquidity in the economy. Consequently, quantitative credit controls were ended in May 1976, and a progressive reduction of reserve requirements was initiated during the second half of the year and continued through 1977.

257. Meanwhile, the major source of reserve money creation had become the rapid buildup of international reserves which grew US$455 million over the course of the year, with surplusses on both current and capital accounts. Concerned with the monetary effects of this rate of reserve growth, and seeing the possibility of striking an important blow against inflationary expectations, the Government twice appreciated the peso--in July 1976 and March 1977--and slowed its crawl. In addition, a two-year minimum maturity was placed on foreign capital entering under Article 14 of the Foreign Exchange Law, and such inflows, when brought through commercial banks, were made subject to the ordinary reserve requirements on foreign currency deposits. These funds continued to flow in in large amounts, however, as the appreciating peso made the large nominal interest rate differential between the domestic and international financial markets even more attractive in real terms.

258. Central Bank rediscount lines were also expanded in 1976. Nevertheless, the strong growth of banking system deposits and the reduction in reserve requirements, along with the diminution of public sector demands, resulted in a significant shift of lending activity from the Central Bank to the private commercial banks. 1/ During 1976, the Central Bank accounted for about one-third of total credit expansion as compared to 85 percent in 1975.

1/ Part of the growth of reserves in the banking system, particularly late in the year, resulted from the withdrawal of deposits from the private finance companies where confidence had been shaken by a number of bankruptcies and cases of management irregularities.

259. The money supply has been growing rapidly in real terms since the middle of 1976, with the authorities attempting to walk the fine line between providing the liquidity needs of a recovering economy in the throes of a major structural transformation and the re-ignition of inflationary expectations among a populace that closely monitors and has become highly sensitized to changes in financial indicators. Superimposed on this short-term management effort have been a series of measures designed to modify the structure of the financial system itself, making it more capable of responding efficiently to market forces, on the one hand, and more sensitive to the over-all regulatory powers of the monetary authorities, on the other. Inevitably, there have been some conflicts between short-term and long-term objectives. The difficulty is perhaps most dramatically illustrated by the very high interest rates that have prevailed at a time when a major long-term priority is to stimulate investment.

b. Interest Rates

260. The maximum legal interest rate during the second half of 1973 was 60 percent per annum, with taxes and other charges bringing the actual nominal cost to the borrower up to about 90 percent. As in previous periods, therefore, those enterprises with access to regulated credit enjoyed negative real interest rates. The large majority of private firms, however, undoubtedly had to rely on internally generated funds or on inter-enterprise credits transacted through the "informal" financial market, perhaps through the intermediation of private finance companies or other unregulated brokers. With their larger retained earnings and superior access to foreign loans as well as subsidized domestic credit, the system generally favored the larger enterprises. At the same time, the dependence on internally generated funds for both working capital and investment resulted in low dividend payouts and probably acted to inhibit development of the stock market.

261. In March 1974, the maximum legal interest rate was raised to 90 percent, and then raised again in May to 200 percent. In real terms, however, bank lending rates remained negative. Also in May 1974, interest rate ceilings were raised entirely from the loans of nonbank financial institutions, stimulating the entry of many new finance companies into the market and permitting them to attract funds away from both the commercial banks and the savings and loan associations. Finally, interest rates throughout the system were effectively freed from controls in May 1975.

262. Tables 6.9-6.10 in Volume III and Figure III.2 trace the evolution since 1974 of short-term (thirty-day) interest rates paid to depositors and charged to nonagricultural borrowers by commercial banks, finance com[illegible] and savings and loan associations (AAPs). 1/ With the freeing of interest rates, the nominal cost of bank borrowing shot up from 9.6 percent per month in April 1975 to 19.0 percent in May, reaching 21.2 percent in July. Of course, on an annual basis the rate for July, for example, exceeded 900 p[illegible]

1/ Farmers with access to the banking system generally enjoyed somewhat lower interest rates as a result of preferential discount rates at Central Bank.

At the same time, the monthly rate of inflation declined sharply, so that the tightness of credit and the lag in inflationary expectations resulted in extremely high real rates of interest averaging more than 7 percent per month for thirty-day money during the final six months of the year. Depositors for the same period received an average of just under 2 percent per month in real terms, indicating a gross spread between deposits and loans of 5-1/2 percent. The Central Bank attempted to apply some downward pressure on interest rates by "suggesting" in October 1975 that nominal savings account interest be limited to 8 percent per month. The moral suasion was more rigorously enforced upon commercial banks than other intermediaries and resulted in a sudden flow of deposits from the former to the latter. In December, the suggestion was withdrawn, and the Government has since resisted pressures to intervene directly in the determination of interest rates.

263. Short-term interest rates changed very little in nominal terms during the first semester of 1976, the real borrowing rate averaging 2.9 percent per month for commercial banks, 3.4 percent for loans from the savings and loan institutions, and 3.7 percent from the finance companies. Deposit rates had become slightly negative in real terms in the case of commercial banks and slightly positive for the nonbank institutions, indicating a still very substantial gross monthly spread of 3-4 percent.

264. In addition to the accelerated expansion of credit begun during the second half of 1976, a number of measures were taken that were expected indirectly to affect short-term interest rates. In May, the Central Bank began to pay interest on commercial bank reserves. That, along with the subsequent lowering of reserve requirements, was intended to reduce banking costs and permit a decline in the gross spread. The revaluation of the peso in July 1976 also had a major impact on inflationary expectations and increased the demand for money and quasi-money. At the same time, the minimum maturity that could be indexed was lowered from one year to 90 days in order to neutralize inflationary expectations, reduce interest rates for that maturity range, and encourage the growth of longer-termed deposits. Also during the second quarter, the AAPs, finance companies and, later, banks were authorized to act as brokers in intermediating commercial paper without incurring a contingent liability or additional reserve obligation. This was intended to increase the flow of credit and improve bank profitability, while at the same time attracting activity away from the largely unregulated and financially precarious informal financial sector. Average nominal interest rates on deposits did fall in response to these measures, but by less than the rate of inflation. Still slower was the reduction of the interest rate on bank loans, which averaged more than 5.5 percent per month in real terms in the second semester of 1976. The gross nominal spread rose from 2.5 percent in June to 4.1 percent in December and 4.6 percent during the first two months of 1977. Since February 1977 the gross spread has shown a strong downward trend reaching nine-tenths of a percent in December 1978.

265. Somewhat greater success was achieved by the second revaluation in March 1977. Coupled with further reductions of the reserve requirement, increased interest earned on reserves, and a strong growth of bank time deposits, the bank lending rate began to fall more rapidly than the rate of change of the consumer price index. As a result, the real monthly interest

rate of thirty-day bank credits fell from 8.4 percent in November 1976 to 2.4 percent by September 1977, the gross spread in the latter months having fallen to 1.4 percent. Interest rates rose again sharply during the final quarter of 1977. Short-term real interest rates charged in 1978, while still considered high, were consistently lower than rates recorded for the corresponding months in 1977. In spite of these variations, the average real rate has been slowly falling since the second semester of 1975. The corresponding average monthly rates for 1976 through 1978 are as follows: 4.24, 3.85 and 3.00 percent. On an annual basis these rates were 65, 57 and 43 percent, respectively.

266. In view of the extraordinarily high interest rates prevailing in Chile since their freeing in mid-1975, it is not surprising that it has constituted a major national issue. To begin with, there is considerable disagreement and surprisingly little hard information regarding the interest rates actually being paid by the majority of enterprises. The short-term credits for which data are systematically available represent only a fraction of total credit, and, it is further argued, the rates being reported are those charged at the margin and are significantly higher than the terms offered prime customers. One widely cited study, carried out in late 1976, reported that many large and medium firms were mixing credits from a variety of sources with a weighted average annual real interest rate of 25 percent. 1/

267. Nevertheless, mission interviews with a large number of enterprises suggest that this study significantly underestimated the costs of borrowing in Chile, even for those enterprises that had a relatively high degree of access to foreign loans. The average annual real cost of short-term, local currency bank credit during the last quarter of 1976 appears to have been around 64 percent, rather than the 55 percent used in the cited study, and lower rates would not have been available from the nonbank institutions. Interest on indexed loans averaged about 12 percent. The cost of foreign credit to the borrower indicated in the study does not apparently include the charge for the required local bank guarantee, which amounted to about 5 percent during the relevant period. Finally, it does not appear that foreign credits, even for the largest enterprises, would have exceeded 40 percent of the total. Application of these corrections generates an estimated average real interest rate of more than 37 percent, and this must be viewed as indicative only for Chile's larger corporations. Smaller enterprises in late 1976 were probably

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1/ The calculation was made as follows: One-third of total credit was estimated to come from the short-term financial market at an average annual real interest of 55 percent; another 16 percent from official lending agencies and development banks, or credit lines discountable at the Central Bank, with indexed interest rates averaging 11 percent; and finally, 52 percent from foreign loans at an average interest rate of 10 percent.

paying something between 50 and 80 percent per year in real terms for their financing. 1/

268. Throughout the period studied, real short-term interest rates have very substantially exceeded the rates attached to indexed long-term securities. A number of factors have contributed to this phenomenon. One has been the strength and intransigence of inflationary expectations which have persistently lagged behind the declines in the actual rate of price increase. Another has been the small demand for long-term financing because of the large unutilized capacity existing in many sectors of the economy; the uncertainties presented by the drastically altered international trade regime; and the severe short-term financial bind created by the economic recession, the prior buildup of inventories in 1974, the heavy debts inherited from the past, and the sudden appearance of positive real interest rates. Finally, one cannot entirely rule out the possibility of at least tacit collusion among the relatively limited number of financial institutions.

269. The high average real interest rate calculated above is, in large part, the result of the concentration of operations at the short end of the market. Real interest charged on indexed long-term transactions does not appear grossly out of line with the likely opportunity cost of capital in Chile presently. The point is, of course, somewhat circular, inasmuch as the unusually high short-term interest rate has tended to attract loanable funds to that end of the market. Through 1976, however, the high interest rate probably did not represent an important impediment to long-term investment. More significant, in the mission's judgment, were the general uncertainties created by the difficult macroeconomic situation through which Chile was passing and the unknown microeconomic implications of the truly major policy reforms which had been invoked. 2/

270. Nevertheless, with economic recovery now well underway, the persistence of such high short-term interest rates inhibits the development of a capital market and makes it difficult to achieve the level of investment required to complete the structural transition intended by the Government's economic program and to set the basis for accelerated long-term growth. Moreover, similar to what occurred in the past, so constricted a financial system gives clear financial advantage to those enterprises with access to foreign funds, those which can draw upon large retained earnings--either their own or from other members of the conglomerate family--and those with corporate ties to banks, development companies, and other financial intermediaries.

1/ The very large gap between foreign and domestic interest rates was maintained by a number of factors including the two-year minimum maturity required of financial inflows, the limit of 100 percent of capital and reserves placed on commercial bank guarantee authority, the credit ceilings imposed by foreign lenders, and the imperfect information existing on both sides of the market. Nevertheless, very substantial funds did flow in in response to the interest rate differential. So attractive was the arbitrage opportunity that several enterprises confided to the mission that they were willing to import goods for resale at little or no (even negative) profit in order to acquire the accompanying trade credits that could be turned over in the domestic money market.

2/ Indeed, the immediate reason for authorizing the development banks to enter short-term operations was reportedly the difficulty they were having in placing long-term funds.

Table III.19: CHILE - QUARTERLY CHANGES IN EMPLOYMENT LABOR FORCE AND THE RATE OF UNEMPLOYMENT IN GREATER SANTIAGO, 1973(IV)-1978 a/

(Percent)

	Change in Employment	Change in Labor Force	Unemployment as percent of Labor Force
1974 (I)	-2.4	-	9.2
(II)	-0.8	0.4	10.3
(III)	2.5	1.4	9.4
(IV)	-0.2	0.2	9.7
1975 (I)	-3.8	0.2	13.3
(II)	-3.5	-0.3	16.1
(III)	-0.9	-0.3	16.6
(IV)	2.1	4.7	18.7
1976 (I)	-	1.4	19.8
(II)	5.0	2.7	18.0
(III)	-0.3	-3.1	15.7
(IV)	4.5	2.0	13.6
1977 (I)	1.2	1.4	13.9
(II)	3.4	2.4	13.0
(III)	0.4	0.2	12.8
(IV)	-0.1	0.3	13.2
1978 (I)	1.3	3.1	14.7
(II)	3.0	0.7	12.8
(III)	1.6	2.8	13.7

a/ Survey taken during last month in quarter.

Source: Appendix Table 1.15

force thus brought the rate of unemployment up to a 9-10 percent range for the entire year. The sharp contraction of economic activity in 1975 inevitably affected the labor market. Nevertheless, the decline in average annual employment, 5.4 percent, was less than half the rate of decline of output. 1/ The peak-to-trough decline in total employment, from December 1974 to September 1975, measured 8.1 percent and was accompanied by substantial withdrawals from the labor force as inferred by the fall in the participation rate.

276. Although absolute employment began to recover during the fourth quarter of 1975, the participation rate also rebounded. Consequently, unemployment continued to mount, reaching a high of 19.8 percent of the Santiago labor force in March 1976. An increase in the participation rate would normally be expected to accompany economic recovery, but the size of the reaction shown in the surveys seems greater than justified by the modest improvement in employment that occurred. A disaggregation of the data by sex shows that the male participation rate fell and remained depressed until the recovery of employment had already been underway for six months. The female participation rate, on the other hand, held fairly steady through 1975

1/ Comprising the averages of the four quarterly surveys in each year. It is also likely that the rate of output decline in Greater Santiago exceeded the nationwide drop of 11.3 percent.

612. Because of the enormous difficulties involved in valuing assets after six years of three-digit inflation, poor maintenance, and technological obsolescence, concentration on rate of return calculations would probably be academic. The mission's concern is instead focused on the issue of resource mobilization and the need to place the growth of public enterprise profits into the overall policy framework that, whether planned or willy-nilly, will determine the size and use of future national savings.

613. Table V.6 showed the enormous potential of the state-owned copper mines for generating profits and public sector savings. In addition, the copper sector continues to serve as a major attraction for foreign savings, whether tapped by CODELCO's external borrowing capacity or through direct foreign investments in new mines. The Government's policy in this regard, however, has not yet been enunciated. For example, although increases in mining capacity are probably achievable at lower cost in the existing CODELCO mines, it may be preferable in the medium term to channel the latter's profits to other sectors while exploiting copper's relative attractiveness to foreign risk capital. The point, once again, is the need to integrate this major revenue source into an overall decision-making framework affecting the level and use of the nation's savings capacity.

614. One of the most important issues affecting public sector programming and public finances, as well as exchange rate and credit policies, stems from the volatility of copper prices. Future upward movements of the copper prices, if they resulted in an appreciation of the peso, would suppress the growth of non-copper exports. The uncertainties created by an exchange rate as volatile as copper prices would also deter exports. At the same time, international reserves must be maintained sufficiently high to buffer the economy against wide swings in external resource availabilities. All of this is known; indeed it has been discussed and analyzed in Chile for years. Yet, no Chilean government has been able to deal satisfactorily with this problem. The windfall profits from a copper price rise will accrue to the Government, and it must be the Government that decides to spend or to save it. Prior administrations found it virtually impossible to resist the pressures to spend, either directly through increased fiscal outlays or indirectly through an effectively appreciated exchange rate.

615. Breaking the link between copper prices and domestic demand requires a mechanism to ensure that copper profits in high price years are held abroad or otherwise sterilized to be drawn down in periods of low copper prices. The Government is now considering establishing such a mechanism. With Chile's international reserves now restored to a reasonable level relative to import demand, implementation of this mechanism should go forward without delay. 1/

1/ Economic history is replete with examples, from Spain in the Siglo de Oro to OPEC today, of government failures to apply prudent demand controls when faced with windfall export receipts. Only Papua-New Guinea has successfully addressed this problem by establishing a special foreign currency account similar to that outlined above to "normalize" the flow of copper receipts to its Treasury.

administration and the rate of inflation. In general, it can be said that the 1975 reform improved the system's horizontal equity by removing large numbers of special exceptions, exemptions and rates. The effective progressiveness of the system was also enhanced by, inter alia, the extension of withholding, the taxation of undistributed corporate earnings, and the indexation of the property tax base. On the other hand, the taxation of capital gains and net worth were ended, and the system has become increasingly dependent on indirect taxes, particularly the VAT. The latter tax was also extended to include a number of basic wage goods previously exempted. Given the high unemployment rate of recent years, the extension of such a high VAT must have had a very adverse impact on Chile's poor.

656. In view of the above-mentioned lack of data, the very high future savings requirements of the economy, and the need to find alternative revenue sources to substitute for high payroll taxes, the mission does not now recommended any major changes of the tax system toward greater progressivity. As the transition proceeds, however, and reduction of the tax burden becomes desirable, it is to be hoped that first attention be given to lowering the very high burden of indirect taxes, principally, the VAT. Reconsideration is also urged of the inclusion of food in the VAT.

extending social security pension coverage to include them. The former option, properly administered, is preferable both for avoiding unnecessary resource waste and for supporting human dignity. Finally, with inflation substantially reduced and continuing to decelerate, it would seem propitious to begin the transition toward a market determination of wages through a revitalized process of collective bargaining. The real wage gains of the past two years, as generated by the legal adjustment formula, cannot be sustained without seriously retarding the growth of employment. At the same time, the rigidity in inter-sectoral, inter-firm, and inter-functional wage differentials introduced by across-the-board legal pay adjustments may tend to exacerbate the already difficult problems of frictional unemployment.

3. The Ownership of Productive Assets

653. The primary determinants of income distribution in the long run are likely to be employment and the ownership of, or access to, non-labor productive assets. Although corroborating data are lacking, it appears certain that the ownership of industrial assets and agricultural land has become more highly concentrated since their return to the private sector after 1973. A number of factors have led to concentration in the industrial sector. Among them are the difficult financial situation many firms faced on their return to private ownership, the compounding of this illiquidity by the reduced cash flows of the 1975-76 recession and the freeing of interest rates, and the financial advantages of those large enterprises which have preferred access to foreign credit and/or to the resources of a domestic financial-industrial-commercial conglomerate. Within the agricultural sector, the major problems are the financial weakness and technical and managerial backwardness of most land reform beneficiaries and their limited access to credit and technical assistance services.

654. The negative implications of the trend toward asset concentration for efficient resource allocation and employment have already been mentioned. Trade liberalization and the resultant pressures of international competition are heavily depended upon to minimize actual market power and the threat to efficiency and income distribution. Chile's distance from world production centers, however, provides many industries with an important degree of natural protection and the opportunity to earn significant monopoly rents. Moreover, large concentrations of economic power seldom remain divorced forever from political influence and may ultimately undermine the economic strategy itself. In addition to the assistance recommended for small enterprises, therefore, the mission urges the Government to tighten and vigorously enforce its antitrust laws and regulations, with particular attention to the links that exist between financial and non-financial institutions.

4. Taxes

655. The greatest improvement in the Chilean tax structure in the last six years has been the elimination of a highly regressive inflation "tax." However, no study has been made of the incidence or overall progressivity of tax collections since the major reform carried out in 1975. Such studies, however, would provide only a rough guide to future collections given the large changes that have occurred in, for example, the efficiency of tax