

## I. THE ECONOMIC AND TRADE ENVIRONMENT

### (1) Major Features of the Economy

1. Since 1990, the Chilean economy has generally experienced solid growth, a reduction of inflation, stability in the external balance and an increase in trade flows. The administration that took office in 1990 committed itself to pursuing policies that would ensure growth with equity. Thus, investment in human capital, through an increase in public expenditure on health and education, has become a priority.<sup>1</sup> This goal is to be achieved using resources in a fiscally responsible manner (see below).

2. The high rates of growth, continuing the trend of the mid-1980s, already seem to have translated into a general improvement in the well-being of the population. GDP per capita has more than doubled since 1990, reaching some US\$4,978 in 1996 (Table I.1). In addition, life expectancy increased from 73 years in 1990 to 75 in 1996; infant mortality per thousand live births decreased from 16 in 1990 to 11 in 1995 and the fertility rate declined from 2.7 births per woman in 1990 to 2.6 in 1994. In 1995, the ratios of primary and secondary school enrolment stood at 96 and 79 per cent.<sup>2</sup>

**Table I.1**  
Basic economic and social indicators, 1990-96

	1990	1991	1992	1993	1994	1995	1996
Population (thousand)	13,100	13,320	13,545	13,771	13,994	14,210	14,419
Urban population (% of total)	83.1	83.4	83.7	84.0	84.2	84.5	84.7
Labour force, female (%)	31.0	30.7	32.0	32.5	32.7	32.4	31.7
Total fertility rate (births per woman)	2.7	2.6	2.6	2.6	2.6	...	...
Infant mortality rate (per 1,000 live births)	16.0	14.6	14.3	13.1	12.0	11.1	...
Life expectancy at birth (years)	72.7	74.4	74.4	74.4	74.4	74.4	75.2
GDP per capita (US\$)	2,308	2,571	3,143	3,305	3,719	4,727	4,978
Annual growth rate average (%)							
- Agriculture	5.98	2.74	7.43	1.49	8.46	5.55	1.80
- Mining	5.50	4.64	2.02	0.93	2.68	7.21	11.86
- Manufactures	1.10	6.56	11.01	5.06	2.89	6.50	3.50
- Services	3.47	8.16	11.52	7.10	4.22	7.92	7.59
Share of total employment (%)							
- Agriculture	18.1	18.1	18.1	16.7	16.2	16.0	15.0
- Mining	2.1	2.0	1.6	1.7	1.6	1.7	1.7
- Manufacturing	15.1	15.7	16.6	16.4	15.6	15.7	15.7
- Services	58.9	58.9	61.4	63.2	63.2	64.7	64.7
Rate of unemployment	5.7	5.3	4.4	4.5	5.9	4.7	5.4
School enrollment ratios (%)							
- Primary school	98	98	96	94	93	96	...
- Primary school, female	97	97	95	98	...	...	...
- Secondary school	74	72	72	75	80	79	...

... Not available.

**Source:** Government of Chile; World Development Report 1996; World Bank, (STARS, World Tables 1995 update, version 3.0) for School enrollment ratios (%); and *Instituto Nacional de Estadística* (INE).

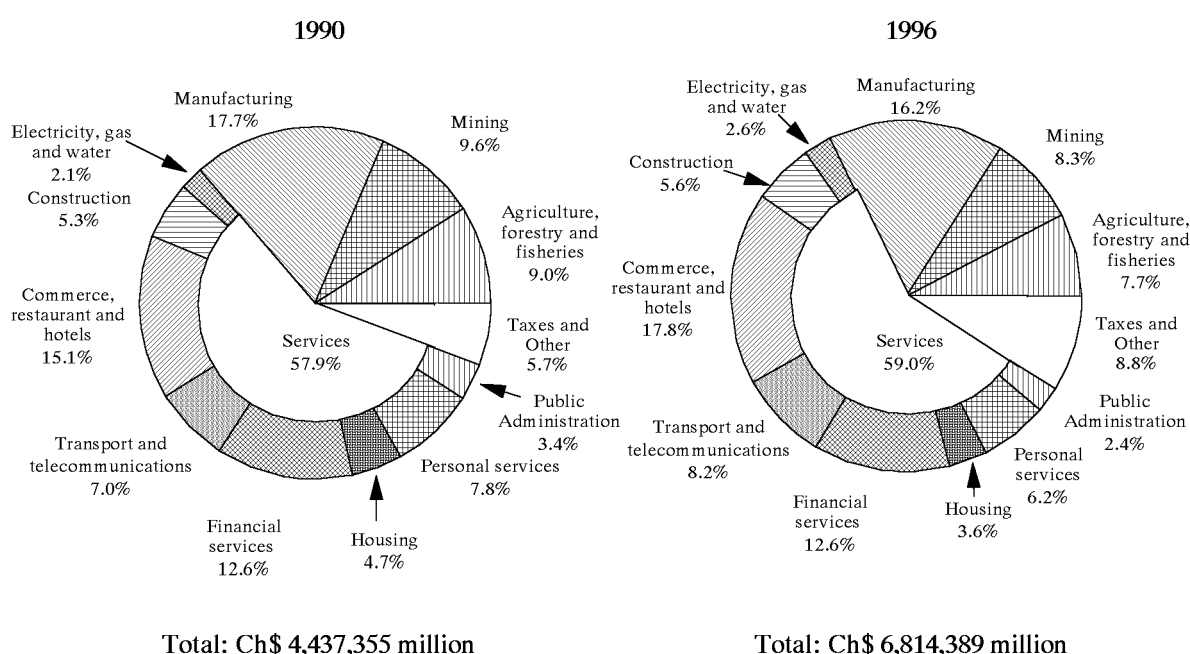
<sup>1</sup>In 1996, the Chilean Congress approved a law to reform the country's educational system. This includes an increase in school hours, an increase in educational funding to schools, and financing to construct additional classrooms (IMF Survey, 28 October 1996).

<sup>2</sup>The U.N. Human Development Report, 1997, ranks Chile 30th in the Human Development Index (HDI) ranking (a composite of life expectancy at birth, adult literacy, education and real GDP per capita on a purchasing power parity basis) - well above its rank in terms of GDP per capita alone.

3. There has been little change in the structure of the economy since 1990 (Chart I.1). Services continues to be the most important sector; its share in GDP amounted to some 59 per cent in 1996. Manufacturing is the second largest sector (16.2 per cent), followed by mining (8.3 per cent), and agriculture, forestry and fisheries (7.7 per cent). The services sector has shown the highest rates of growth since 1990 (with the exception of agriculture and mining which grew at faster rates in 1994 and 1996) and is the major employer (Table I.1). However, throughout the period all sectors have grown at respectable, albeit variable, rates (Table I.1).

**Chart I.1**  
**Sectoral distribution of GDP, 1990 and 1996**

(Per cent and constant 1986 prices)



Source: Government of Chile.

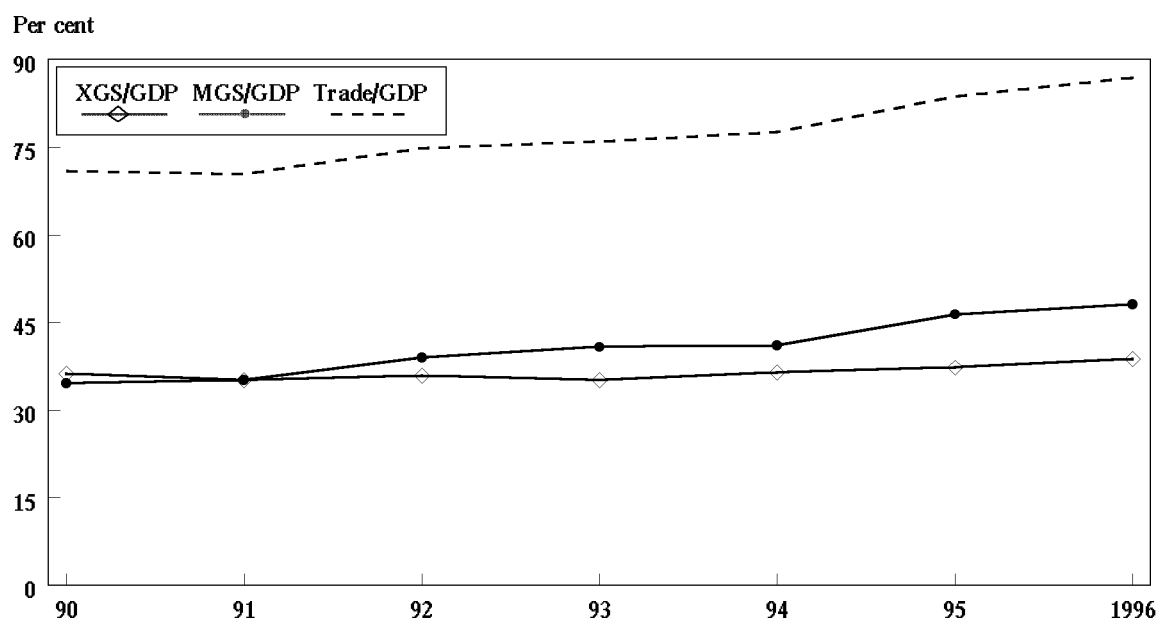
4. Trade has become increasingly important for Chile given the opening up of the economy, a policy which dates from the 1970s. Imports and exports have been growing steadily since 1986, and the ratio of trade in goods and non-factor services to GDP is now close to 90 per cent (Chart I.2). As discussed later, the most important export sectors are mining, agriculture, forestry and fisheries.

## (2) Recent Economic Developments

5. Since 1990, against the background of large capital inflows, the main objectives of Chilean macroeconomic policy have been the gradual reduction of inflation, the maintenance of a sustainable external position (a current account deficit of about 3-4 per cent of GDP), a manageable fiscal balance, and the promotion of growth with equity. Monetary policy has been aimed at keeping short-term interest rates at a level consistent with the inflation target. Fiscal policy has been aimed at keeping public spending growth at a rate that would also avoid inflationary pressures; this approach has also contributed to an increase in public savings and modest fiscal surpluses. The exchange rate has been maintained within a range deemed consistent with the external balance, and its volatility has been limited through the management of an exchange rate band. Restrictions on the capital account are intended to dampen

short-term and speculative capital flows. These measures have been coupled with structural reforms; namely unilateral trade reform, a programme of privatization and an increase in social expenditure. The programme as a whole has resulted in sustained growth, lower inflation and the strengthening of the external position.

**Chart I.2**  
**Trade in goods and non-factor services as shares of GDP, 1990-96**



Note: XGS and MGS denote exports (X) and imports (M) of goods and non-factor services. The percentages were computed using data at constant 1986 prices.

Source: Government of Chile.

(i) Composition and growth of GDP

6. Chile has achieved sustained economic progress in the 1990-96 period in a context of prudent, market-oriented economic policies. During this period annual real GDP growth averaged 7 per cent, inflation fell from 27.3 per cent to 6.6 per cent (Table I.2, Chart I.3). After the slowdown of the economy in 1990, following the Government's contractionary fiscal and monetary policies to bring inflation under control, the economy started growing again. However, in 1994, GDP growth slowed to 4.2 per cent after another period of adjustment, recovering strongly in 1995, despite the difficult international context of the post-Mexico crisis: real output increased to 8.5 per cent and inflation fell from over 8.9 per cent during 1994 to 8.2 per cent in 1995 (Table I.2). During 1996 the economy continued to grow, while inflation decreased to 6.6 per cent. Unemployment also fell from 5.9 per cent in 1994 to 4.7 per cent in 1995, increasing in 1996 to 5.4 per cent (Table I.1).

7. The IMF estimates that output growth during 1990-1995 reflects in large part an acceleration in capital formation together with an increase in the quality of capital.<sup>3</sup> During 1991 to 1995, the accumulation of capital was considered the main engine of growth. The substantial growth of output

<sup>3</sup>IMF Survey, 16 December 1996.

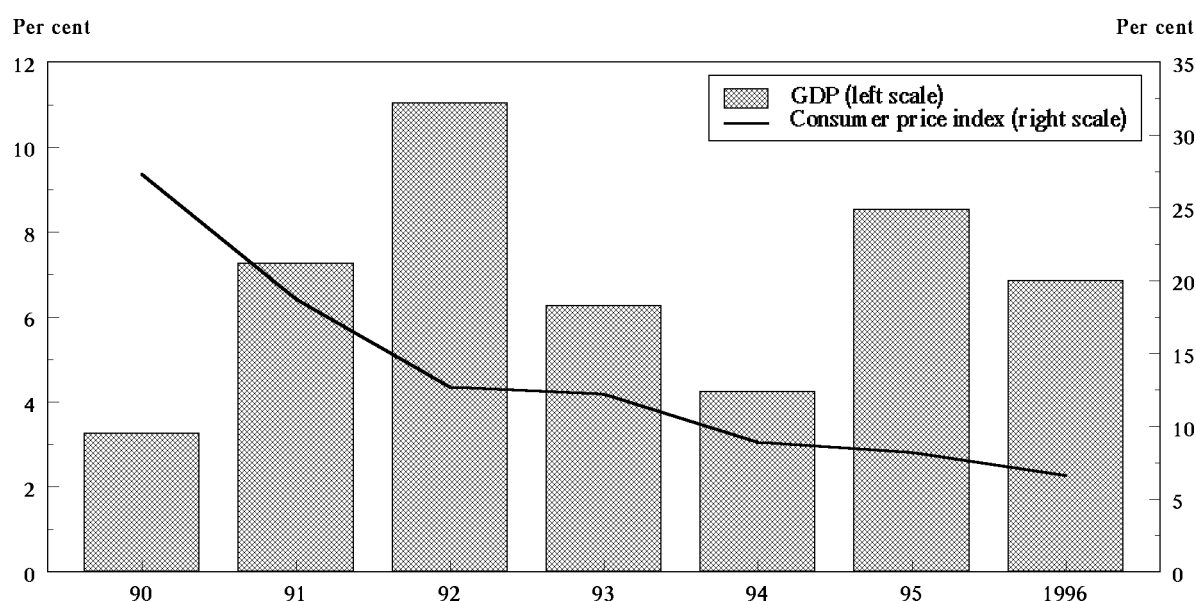
was due mainly to the increase in the investment rate and the rising share of machinery and equipment in total capital, with associated growth in labour productivity.

**Table I.2**  
**Economic performance, 1990-96**

	1990	1991	1992	1993	1994	1995	1996
Annual growth rate average (%)							
Gross national product	4.7	7.4	11.5	7.9	3.5	10.1	6.0
Gross domestic product	3.3	7.3	11.0	6.3	4.2	8.5	7.2
Annual growth rate average (%)							
- Private consumption, etc.	0.4	8.9	11.6	8.1	4.4	11.7	8.8
- General gov't consumption	1.1	4.3	5.3	3.3	2.3	2.3	2.5
- Gross domestic investment	4.0	1.6	26.0	12.5	1.0	19.0	7.4
Resource balance (annual growth rate average)							
- Exports of goods & NF services	9.7	10.7	13.5	4.2	8.2	11.4	10.5
- Imports of goods & NF services	3.6	8.5	23.5	11.2	5.1	22.2	10.6
Competitiveness indicators, (annual growth rate average)							
- Consumer price index (Dec.-Dec.)	27.3	18.7	12.7	12.2	8.9	8.2	6.6
Annual growth rate average (%)							
Monetary survey							
- Money plus quasi-money (M2)	32.1	32.6	41.1	28.1	21.6	23.7	27.2
- Money as means of payment (M1)	15.6	43.4	40.3	19.1	17.8	22.5	16.3
Interest rates							
- Deposits 90 days to 1 year	9.5	5.4	5.3	6.4	6.4	5.9	6.9
- Lending 90 days to 1 year	13.3	8.5	8.1	9.2	9.3	8.5	9.3
Share of GDP (%) (1986 Ch\$)							
- Private consumption, etc.	0.4	8.9	11.6	8.1	4.4	11.7	8.5
- General gov't consumption	1.1	4.3	5.3	3.5	2.1	2.3	2.5
Share of GDP (%) (current Ch\$)							
- Gross domestic investment	26.3	24.5	26.8	28.8	26.8	27.4	28.1
- Gross domestic saving	24.2	24.1	24.8	23.9	25.4	27.6	24.8
Fiscal balance (% of GDP in current Ch\$)							
- Government current revenue	20.5	22.3	22.4	22.6	21.9	21.5	21.4
- Government current expenditure	18.1	18.6	17.5	17.7	17.2	16.2	16.6
- Government capital payments	2.3	2.5	2.8	3.1	3.3	3.0	3.3
- Government deficit (-) or surplus	0.1	1.2	2.1	1.8	1.4	2.3	1.5

Source: Government of Chile.

Chart I.3  
Growth in real GDP and consumer price index, 1990-96



Source: Government of Chile.

8. Investment has been a major demand component since 1992, with the exception of 1994 when it declined substantially, increasing again in 1995 (Chart I.4). Consumer demand has also been positive throughout the period, but less important than investment. The contribution of exports to demand has traditionally been positive, consistent with the continuous process of opening up the economy since the mid-1970s. The focus of government spending has changed. Overall government consumption declined between 1992 and 1994, remaining stable since, as a result of tight fiscal discipline and targeted public expenditure.<sup>4</sup>

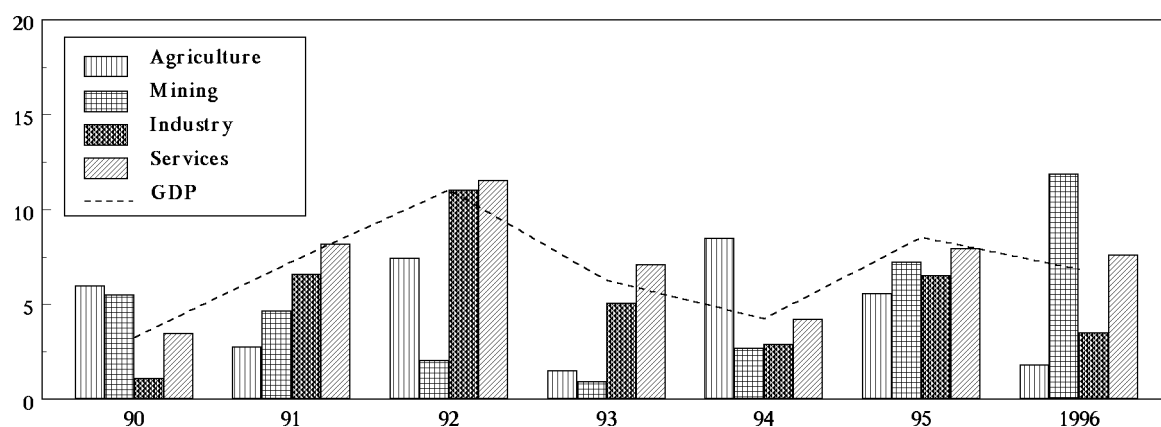
9. Domestic savings have covered an increasing proportion of investment. Savings increased rapidly from 1985 to 1988 (the GDS/GDP ratio rising from 7.5 to 22 per cent), and, since the late 1980s, both savings and investments as percentage of GDP have run closely in parallel, showing a steady upward trend to reach 25 per cent in 1995 (Chart I.4). The savings ratio registered small declines only in 1993 and 1996, which coincided with a deterioration of the terms of trade (Table I.4).

<sup>4</sup>Social expenditure increased to 61 per cent of total public expenditure in 1995 from 55 per cent in 1990, with increases concentrated in education, health, and housing. Throughout this period, social expenditure represented 13 per cent of GDP, while overall public expenditure declined to 20.9 per cent of GDP in 1995 from 23.3 per cent in 1990 (IMF Survey, 28 October 1996).

**Chart I.4**  
**Selected indicators of macroeconomic development, 1990-96**

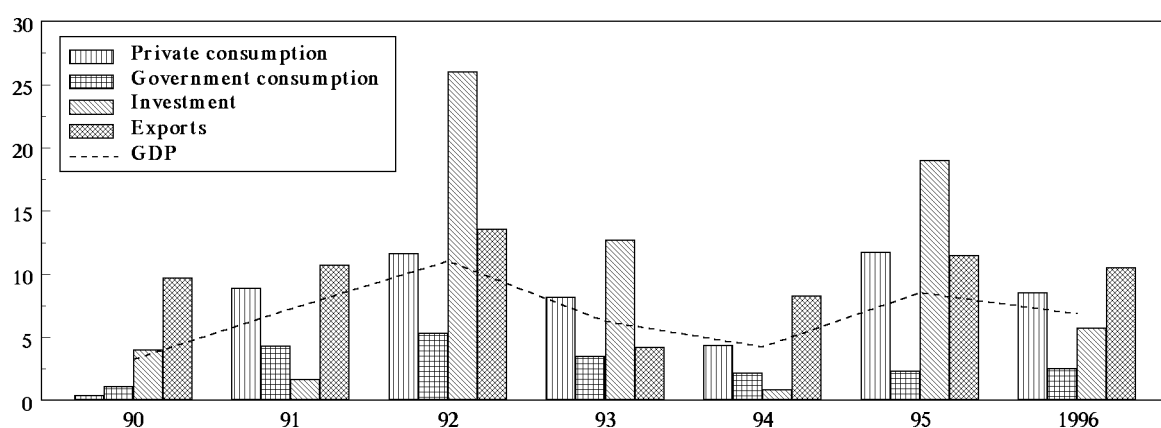
**(a) Contribution of supply components to growth**

Per cent



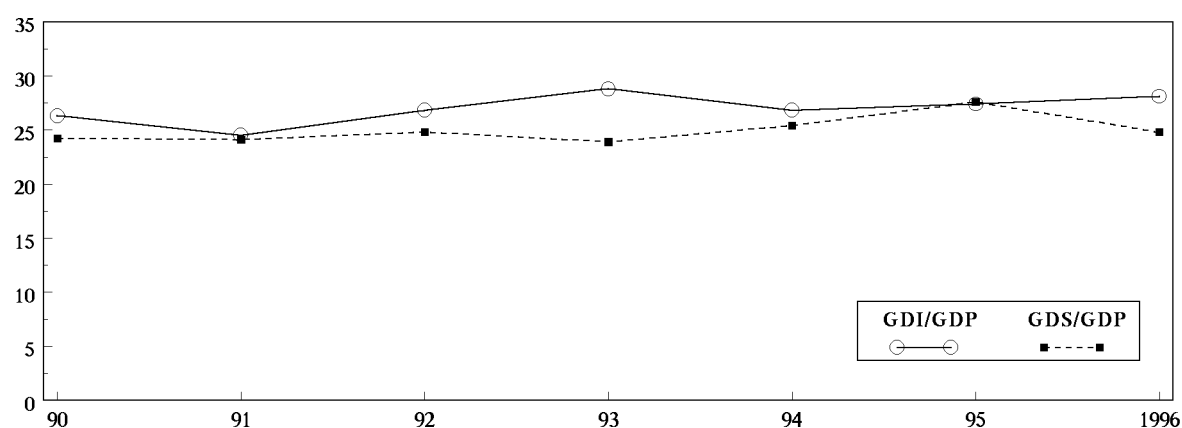
**(b) Contribution of demand components to growth**

Per cent



**(c) Savings and investment (% of GDP in current Ch\$)**

Per cent



Source: Central Bank of Chile; Government of Chile.

(ii) Public finances

10. The tight fiscal discipline adopted since 1990 has generated an increase in the public savings and surpluses in the fiscal balance, amounting to 1.5 per cent of GDP in 1996 (Table I.2). There seems to be a positive correlation between copper prices and public finances: for instance, the increase in the surplus of the public sector from 1.4 per cent of GDP in 1994 to 2.3 per cent in 1995 occurred at times of exceptionally high copper prices.<sup>5</sup> Such a linkage is to be expected, given the importance of copper and the fact that CODELCO, the world's leading producer, is a State-owned company. However, in order to reduce the volatility of fiscal income the Chilean Government operates a copper stabilization fund. Thus, if the price of copper is four to ten cents above an annually determined baseline price, the surplus will be evenly distributed between the fund and current expenditure. If the price of copper is ten cents above the baseline price the surplus will be wholly deposited in the fund. The same margins apply when the price of copper falls below the baseline price and resources are drawn out of the fund to supplement current fiscal income.

11. One of the goals of the Government that took office in 1990 was to promote growth with equity. As stated by the authorities, this required a major increase in public expenditure in areas such as health, housing and education. However, to meet this commitment while maintaining fiscal equilibrium and macroeconomic stability, a higher level of tax collection was deemed necessary. Thus, in 1990 the Government introduced a temporary tax reform which, *inter alia*, raised the corporate income tax rate and restructured personal income tax brackets to increase moderately the progressivity of the personal income tax. The income tax base was also widened. After an evaluation of the effects of the 1990 reform, a second reform in 1993 was intended to take into greater account long-term fiscal expenditure requirements (Box I.1). This reform included a scheme of gradual reduction of the top income tax rate, and of the VAT (during 1994-97).

12. In 1995, the law regulating income tax was modified to help reduce tax evasion. In addition, the excise tax on tobacco was increased from 52.9 to 55.4 per cent, and that on gasoline from 3.4893 UTM to 4.4084 UTM per cubic metre.<sup>6</sup>

13. Further tax reforms, currently under consideration, would include a further reduction of import duties.<sup>7</sup> Such a reduction in trade taxes should improve the allocation of resources by reducing differential treatment of tradeables and non-tradeables. It should also reduce the negative effect of import taxes on exports of goods and services.

14. Despite the two fiscal reforms neither the tax structure nor the tax revenue has varied much (Table I.3). Total tax collection as a percentage of GDP, increased from 14.5 in 1990 to 17.8 per cent in 1996. VAT continues to be the principal source of revenue, followed by income tax whose collection in terms of GDP increased markedly between 1990 and 1991, probably due to the fiscal reform. The contribution of import duties has stood at around 2 per cent of GDP since 1990, thus the decrease in import duties from 15 to 11 per cent in 1991 did not substantially reduce fiscal revenue; this can be attributed to the continuous increase of imports as a percentage of GDP since 1991 (Chart I.1).

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<sup>5</sup>Annual average copper prices (US cents per lb.) at the London Metal Exchange were: 103.57 in 1992; 86.71 in 1993; 104.90 in 1994; 133.50 in 1995; and 103.89 in 1996 (*Banco Central de Chile* (1997)).

<sup>6</sup>On 1 June 1997, 1 UTM was equivalent to Ch\$23,861 and US\$1 = Ch\$418.6.

<sup>7</sup>The range of the reduction has not been officially announced, but reductions of 3 and 4 percentage points have been reported (*Wall Street Journal*, 22 April 1997 and *El Mercurio*, 5 June 1997).

**Box I.1: Tax Reforms**

1. 1990 Tax Reform

Value-added tax (VAT)

- Rate raised provisionally from 16 per cent to 18 per cent until December 1993.

Income tax

- Taxation on the basis of corporate profits restored.
- Corporate income tax rate raised provisionally from 10 to 15 per cent until December 1993.
- Number of personal income tax brackets reduced from eight to six, increasing tax progressivity.
- Abatement mechanism introduced allowing 2 per cent of the value of new corporate assets to be deducted from profits tax, up to a maximum abatement of 500 UTM per year.
- Use of the tax system based on actual income restricted to small taxpayers in the agricultural (annual sales below 800 UTM), mining (annual sales below 72,000 UTM) and land transport (annual invoicing of services below 3,000 UTM) sectors.

2. 1993 Tax Reform

Value-added tax (VAT)

- VAT rate set at 17 per cent, but to be maintained at 18 per cent during 1994 and 1995; in 1996 and 1997 the President of the Republic may maintain the rate or lower it according to macroeconomic conditions. The law provides for VAT to be definitively lowered to 17 per cent in 1998. However, a bill is currently being prepared and under legislative discussion to maintain the VAT rate at 18 per cent.

Income tax

- Corporate profit tax maintained at 15 per cent.
- Tax scale in force until 1990 reintroduced, with a reduction in the top rate from 50 to 45 per cent.
- New savings incentive introduced, consisting of deferred taxation of personal income devoted to saving, taxation only when withdrawn from savings.
- Expenses incurred by private enterprises for educational projects through grants to non-profit-making educational establishments allowed as credits against profits tax.
- Allowance made for Chilean enterprises investing abroad for part of the taxes paid on investments in destination countries.
- Profits tax rebate increased from 2 to 4 per cent of the value of new corporate assets, with the maximum rebate maintained at US\$20,000.



**Table I.3**  
**Tax revenue, 1990-96**  
(Current Ch\$ billion and per cent)

	1990	1991	1992	1993	1994	1995	1996
<b>Ch\$ billion</b>							
Total tax collection	1,343.6	2,012.0	2,623.7	3,250.6	3,742.7	4,400.6	5,202.8
Income tax	237.8	494.3	632.0	759.2	881.0	998.2	1,227.5
VAT	649.8	932.8	1,268.4	1,588.4	1,831.2	2,128.2	2,492.1
Tariffs	222.5	276.3	334.9	413.1	429.3	836.6	616.7
Specific taxes	177.7	240.3	292.3	342.7	393.5	476.6	574.3
Other	55.7	68.4	96.1	177.2	207.8	262.1	292.0
<b>Per cent of GDP<sup>a</sup></b>							
Total tax collection	14.5	16.7	16.9	17.6	17.1	16.5	17.8
Income tax	2.6	4.1	4.1	4.1	4.0	3.7	4.2
VAT	7.0	7.8	8.2	8.4	8.4	8.0	8.5
Tariffs	2.4	2.3	2.2	2.0	2.0	2.0	2.1
Specific taxes	1.9	2.0	1.9	1.9	1.8	1.8	2.0
Other	0.6	0.5	0.5	1.0	0.9	1.0	1.0

a GDP in current *pesos*.

Note: Some of the percentages do not add to 100.0 because of rounding.

Source: Government of Chile.

15. Chile has continued the process of privatization noted in the previous Trade Policy Review (the first two rounds of privatization took place in 1974-79 and 1984-89).<sup>8</sup> In 1993, 49 per cent of the companies operating in the Iquique duty-free zone were privatized. In 1994, the freight division of the National Railroad company was auctioned, and the Government sold part of its stock in an airline company (Lanchile) and an electrical utility (Edelnor).<sup>9</sup> CODELCO sold 26 per cent of its main electricity plant to private investors in early 1996 and is expected to sell another 50 per cent before the end of 1997. Procedures to privatize a major state-owned electricity concern were initiated in the second quarter of 1997.

### (iii) Monetary policy

16. Since autonomy was granted in 1989, the Central Bank has focused its policies towards the systematic reduction of inflation rates, keeping a strong growth performance and a sustainable external position. The Bank's main objectives are price stability, stability of foreign transactions and payments, and stability of domestic payments. In order to achieve these objectives, monetary policy focuses on rates instead of monetary aggregates. Since May 1995, interbank rates are set to control absorption. The basic instruments used to control interbank rates are the discount rate structure, net purchases of Central Bank papers, banking reserve requirements, repurchase agreements and reverse repurchase agreements.

<sup>8</sup>During the first round, banks were privatized, followed by manufacturing firms. The first round ended with the 1982 crisis (Edwards, 1996). The second round of privatizations affected sectors such as telecommunications, electricity, and steel production.

<sup>9</sup>These companies were owned by the Production Promotion Corporation, CORFO.

17. The Central Bank has been successful in bringing down inflation. Inflation has been decreasing gradually since 1990, when average CPI (December-December) growth was over 27 per cent, to reach a level of 6.6 per cent in 1996. While inflation is still above industrial-country levels, the authorities consider that, given the inflationary history of the country, the achievement of single-digit inflation is a success. Nevertheless, monetary policy will remain consistent with their long-term inflation target, i.e. to reduce inflation to industrial-country levels.

18. One difficulty in bringing down the rate of inflation is the widespread indexation in the Chilean economy. Indexation, linked to past inflation, affects goods and services, labour, foreign exchange and financial markets.<sup>10</sup> The use of this mechanism has contributed to inflationary inertia, thus requiring stronger monetary or fiscal efforts to curb price increases.<sup>11</sup> Reducing inflation to industrial-country levels would be facilitated by reducing the scope of indexation.

(iv) Exchange rate developments

19. Since 1992, exchange rate policy has been based on a crawling band, whereby the reference nominal currency value is pegged to a basket of hard currencies. Since January 1997 the basket has been defined 80 per cent on the US dollar, 15 per cent on the Deutsche mark and 5 per cent on the Japanese Yen. The rate of crawl of the reference rate is adjusted daily with respect to the basket of currencies by the difference between domestic and estimated foreign inflation. In addition, since November 1995, the Central Bank has included a factor reflecting the trend rate of appreciation of the currency that corresponds to an assessment of the medium-term evolution of the real exchange rate. Given the differential in productivity growth between Chile and its trading partners, this factor was estimated as 2 per cent per year. The interbank exchange rate in Chile, for official and other transactions, is allowed to fluctuate within a 12.5 per cent band on each side of the reference rate.<sup>12</sup> The Central Bank can also intervene to adjust the exchange rate when it is inside the band.

20. In real terms, the Chilean *peso* has been gradually appreciating since 1990 at an annual rate of 4.6 per cent, equivalent to an accumulated appreciation of 24 per cent, during 1990-96.<sup>13</sup> The authorities have noted that the tendency of the currency to appreciate corresponds to the increase in productivity during the same period. Chart I.5 shows that despite the real effective appreciation of 20 per cent of the *peso*, exports have grown continuously since 1990, with the exception of 1993 when the price of copper declined significantly.

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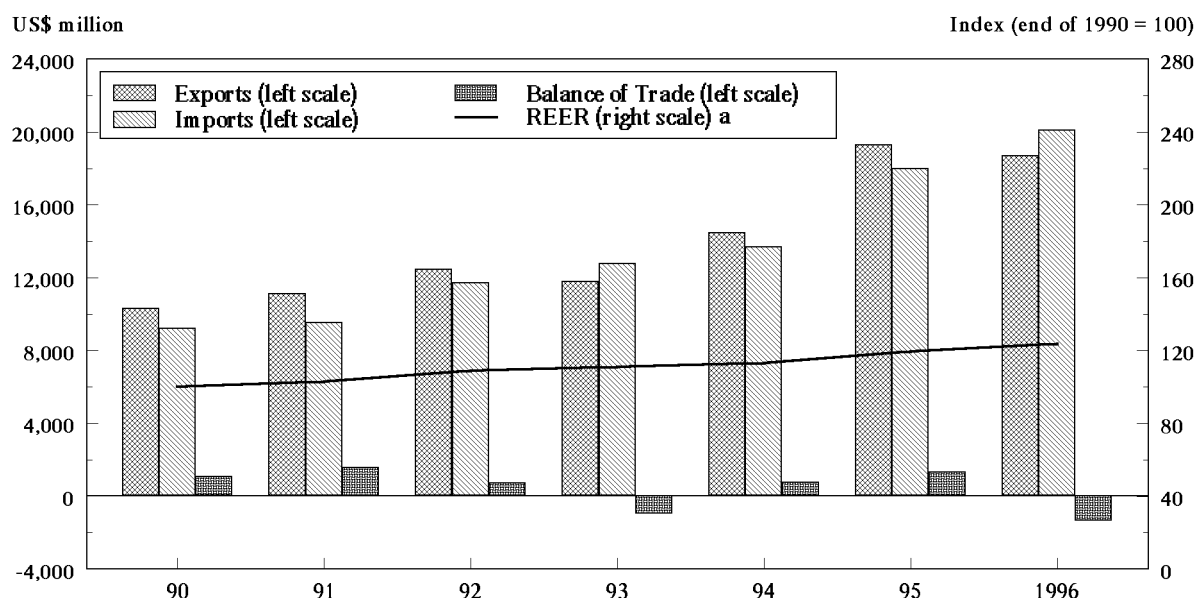
<sup>10</sup>Projected inflation (in contrast with past inflation) is a key element in determining public-sector wage increases.

<sup>11</sup>The practice was facilitated by the introduction in 1967 of a unit of account, the UF (*unidad de fomento*), published by the Central Bank on a daily basis, and linked to the consumer price index with a lag of one month. This unit of account is used in the markets of durable goods and for services; as well as for most financial contracts.

<sup>12</sup>*El Mercurio* (International Edition), 16-22 January 1997.

<sup>13</sup>Government data.

**Chart I.5**  
**REER index and trade in goods and non-factor services, 1990-96**



a An increase (decrease) indicates appreciation (depreciation).

Source: Government of Chile; and International Monetary Fund, *International Financial Statistics* (1997).

21. The official foreign exchange market consists of commercial banks, authorized exchange houses, and other entities licensed by the Central Bank. An informal, but legal, exchange market covers all transactions not required to be channelled through the official market. The exchange rate is freely determined in this market.<sup>14</sup> However, the ongoing liberalization of the capital account has allowed a considerable unification of the exchange rate market, and the spread between the primary and secondary exchange rate has become negligible.

22. Foreign exchange policy complements both monetary and fiscal policy in the Government's objective of achieving a sustainable current account deficit (i.e. 3-4 per cent of GDP). This policy is not targeted at fixing the real exchange rate, but at stabilizing the long-term value of the exchange rate and avoiding speculative capital movements in order to ensure a sustainable-trend deficit of the current account.

23. To avoid the damaging effects of speculative capital the capital account has not been fully opened; its complete liberalization is one of the Central Bank's main future policy challenges. The current regulations pursue three objectives: (i) to modify the composition of capital flows, favouring long-term and equity-related flows and taxing relatively more volatile flows such as short-term inflows; (ii) to ensure the effectiveness of monetary policy; and (iii) to support prudential regulation of financial institutions.

<sup>14</sup>IMF (1996).

24. Capital control instruments include reserve requirements on portfolio and debt inflows, one-year minimum permanence requirement on foreign direct investment, and limits on the quantity and type of external assets that financial institutions can hold. Among them, the most important is the one-year unremunerated reserve requirement, set in 1992 at 30 per cent. The authorities view this reserve requirement on all foreign borrowing as necessary to support interest rate policy, while avoiding undesirable upward pressure on the value of the *peso*, which could weaken the competitiveness of Chilean exports.

25. Nevertheless, the capital account has been further liberalized. Since June 1995 exporters have not been required to surrender export proceeds to the Central Bank, although they are still required to inform the Central Bank of these operations for statistical purposes. Moreover, in August 1995, the Central Bank eliminated Chapters XVIII and XIX of the Compendium of Foreign Exchange Regulations, thus lifting restrictions on profit remittances abroad and capital repatriation for selected Chilean foreign debt instruments. In addition, restrictions to access the formal exchange market have been eliminated for some investment operations abroad and limits for institutional investment abroad have been widened.

(v) Balance of payments

26. As shown in Table I.4, in the period 1990-96, Chile ran a current account deficit almost every year, with the exception of 1991 and 1995. These deficits have been mainly financed by long-term capital inflows. According to the authorities, the bulk of growth financing has come from domestic sources, showing a limited reliance on capital inflows.

27. Fluctuations in the trade balance of the current account are strongly linked to the evolution of the terms of trade, given the importance of copper in Chilean exports. For instance, in 1993 the external current account widened, reflecting mainly a deterioration in terms of trade.<sup>15</sup> Similarly, in 1995, the Central Bank projected a surplus in the current account for 1996, which did not materialize because of a decline in the terms of trade.<sup>16</sup> Thus, despite increased export diversification, the Chilean economy remains highly sensitive to copper price fluctuations (see below).

28. The authorities have estimated that these deficits are sustainable as long as they remain around 3 to 4 per cent of the GDP. As noted, current account deficits have been mainly financed with foreign capital, loans being of lesser importance; there were net outward payments of loans in 1995 and 1996. The authorities consider the use of external financing as a fundamental complement to national savings to finance investment projects. However, they noted, that this source of financing should be used cautiously, that the size of the deficit has to be monitored and that overall economic policy should actively control global expenditure.

29. The capital account balance has been positive since 1990. Net long-term capital inflows have been positive throughout the period despite some fluctuations. After an acute decline in 1995, mainly because of significant debt pre-payments made by the Central Bank and the public sector, and in part as a consequence of the Mexican financial crisis, which reduced temporary portfolio inflows, inflows of long-term capital recovered in 1996. The accumulation of foreign reserves has been substantial throughout the period.

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<sup>15</sup>The price of copper declined from 103.57 (US cents per lb.) in 1992 to 86.71 in 1993 (*Banco Central de Chile* (1997)).

<sup>16</sup>*Banco Central de Chile* (1996).

**Table I.4**  
**Balance of payments, 1990-96**  
 (US\$ million)

	1990	1991	1992	1993	1994	1995	1996
Overall balance	2,631	1,058	2,305	767	4,053	1,577	2,219
- Current account balance	-537	110	-698	-2,077	-639	148	-2,918
- Trade balance	-736	-230	-1,130	-2,447	-997	-162	-3,391
- Merchandise trade balance	1,336	1,587	771	-982	725	1,481	-1,147
- Merchandise exports, f.o.b.	8,373	8,941	10,008	9,199	11,604	16,136	15,353
- Merchandise imports, f.o.b.	7,037	7,354	9,237	10,181	10,879	14,655	16,500
- Non-factor services, balance	-261	-8	-41	3	21	-163	-229
- Factor services, balance	-1,811	-1,809	-1,860	-1,468	-1,743	-1,480	-2,015
- Private current transfers, net	54	40	74	61	53	56	101
- Official transfers, net	145	300	358	309	305	254	372
- Capital account balance	3,168	948	3,003	2,844	4,692	1,429	5,137
- Long-term capital inflow, net	1,586	366	906	1,654	3,118	789	4,718
- Long-term loans, net	651	-220	133	550	1,364	-218	603
- Foreign direct investment, net	582	400	321	374	846	971	3,013
- Foreign direct investment	590	522	699	808	1,772	1,667	4,092
- Direct investment abroad	8	122	378	434	926	696	1,079
- Other long-term capital, net	353	186	452	730	908	36	1,102
- Other capital inflow, net	1,463	463	1,978	1,071	1,455	521	300
Errors and omissions	-143	298	315	-70	-740	-396	-917
Changes in international reserves <sup>a</sup>	-2,368	-1,238	-2,498	-578	-3,194	-1,061	-1,181
Memorandum items							
Terms of trade index (1987= 100: US\$ based)	114.8	116.6	117.4	106.6	122.9	141.2	117.6
External debt	17,425	16,364	18,242	19,186	21,478	21,736	23,049
Debt servicing/Exports of goods and NF services (%)	20.3	19.8	17.9	17.9	17.7	14.9	16.7

a Negative sign indicates increase.

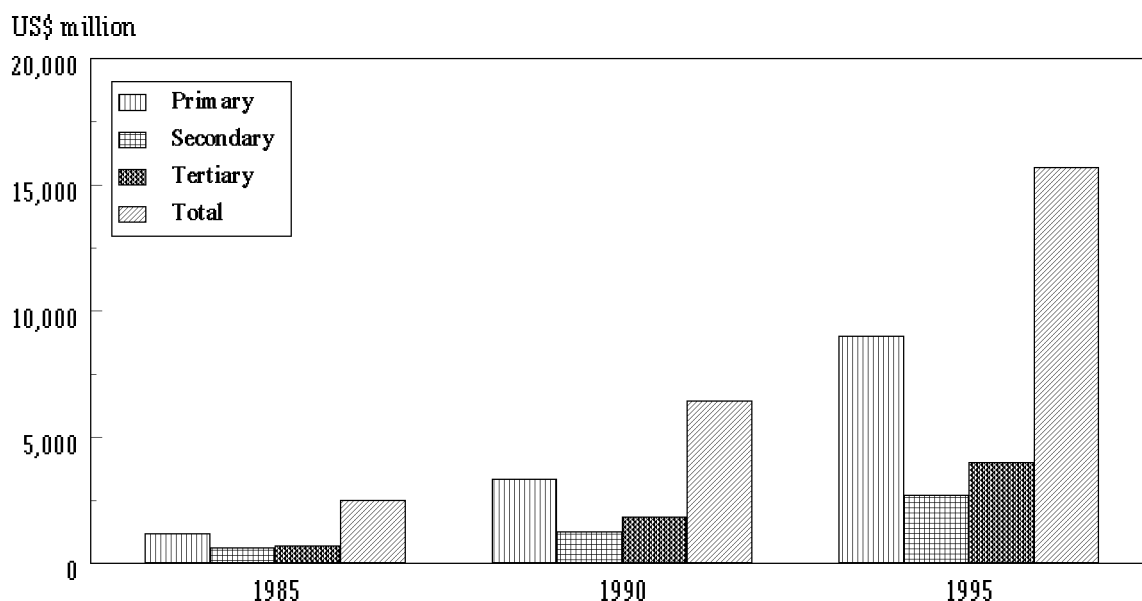
Source: Government of Chile.

30. From 1985 to 1995, foreign direct investment in Chile increased substantially (Chart I.6).<sup>17</sup> Cumulative total inflows increased from less than US\$2,500 million to more than US\$15,000 million. The increase in foreign investment has been most pronounced in the primary sector, mainly in mining. However, the sectoral pattern of investment has changed little since 1985. Historically, the primary sector has attracted most foreign capital, followed by services and industry. The most important investors in Chile are the United States, followed by the European Union and Canada; among the Latin American countries Argentina is the most important investor.<sup>18</sup>

<sup>17</sup>These data include only foreign investment transactions which have entered Chile under DL 600. There have been no foreign investment transactions under Chapter XIX of the Compendium of Rules of International Exchange, which governs the purchase of selected Chilean foreign debt instruments abroad, since 1991.

<sup>18</sup>*Comité de Inversiones Extranjeras* (1996).

**Chart I.6**  
**Foreign direct investment cumulative inflows by sector, 1985-95**



**Note:** Data calculated on the basis of cumulative flows of FDI since 1974.

**Source:** *Comité de Inversiones Extranjeras, Chile Inversión Extranjera en Cifras 1974-1995.*

31. Chilean direct investment abroad has increased from US\$8 million in 1990 to US\$1,079 million in 1996 (Table I.4). The major destination of Chilean investment abroad is Latin America. Chile's outward investment in Latin America has been concentrated in services and electricity generation; however, there has also been some investment in manufacturing industries such as paper, steel, sweets, ceramic and copper.<sup>19</sup>

### (3) Composition and Direction of Trade

32. Chile has pursued trade liberalization on a multilateral basis for many years and presently the country maintains an open-trade system with a uniform tariff of 11 per cent (Chapters II and III). This has contributed to a significant growth of trade; exports and imports of goods and services were equivalent to some 90 per cent of GDP in 1996 (Chart 1.2).<sup>20</sup> There was some variation in the composition and direction of trade in the period 1990-95.

#### (i) Composition of merchandise trade

33. Chile exports mainly primary products: agricultural, forestry and mining. These exports accounted for more than 80 per cent of total exports during the period under study (1990-95) (Table AI.1). Copper continues to be Chile's major export, though its importance has somewhat declined. In 1990, exports of copper amounted to some 46 per cent of total exports, declining to

<sup>19</sup>Latin American Weekly Report, 22 August 1996.

<sup>20</sup>Based on constant price data.

40 per cent in 1995 (Chart I.7). There has been some export diversification, mainly in forestry, food products and animal feed. Exports of forestry products and wine have increased, with exports almost doubling since 1990, but exports of other agricultural products (such as fruits) show a decline (Table AI.1).

34. The composition of imports has remained more or less stable, with manufactured goods amounting to some 79 per cent of total imports in 1995, of which, machinery and transport equipment are the most important items (Table AI.2).

(ii) Direction of merchandise trade

35. Chile's major export destination in 1990 was the European Union; however, in the last five years this market has lost some significance. The United States, also became a less important destination of Chilean exports, though it still holds some 12 per cent of the market. Latin American and Asian countries have become more important markets for Chile. In recent years, Chile has sought to strengthen commercial relations with Latin American partners through trade agreements, of which the most recent is its association with MERCOSUR (Chapter II). These agreements have resulted in an increase in the share of Chile's exports to the region, from 12.7 to 19.4 per cent between 1990 and 1995 (Table AI.3). Chile has also successfully promoted its exports in the Asian region, with exports to East Asia increasing from 25 per cent in 1990 to 33.5 per cent in 1995.<sup>21</sup>

36. Since 1995, there has not been a substantial change in the origin of Chilean imports. However, the European Union again lost some importance as a supplier, while the United States, and, especially, the rest of the Americas, have become more important suppliers (Table AI.4). In the latter case, this may again be explained by the free-trade agreements that have been signed with the Latin American countries.

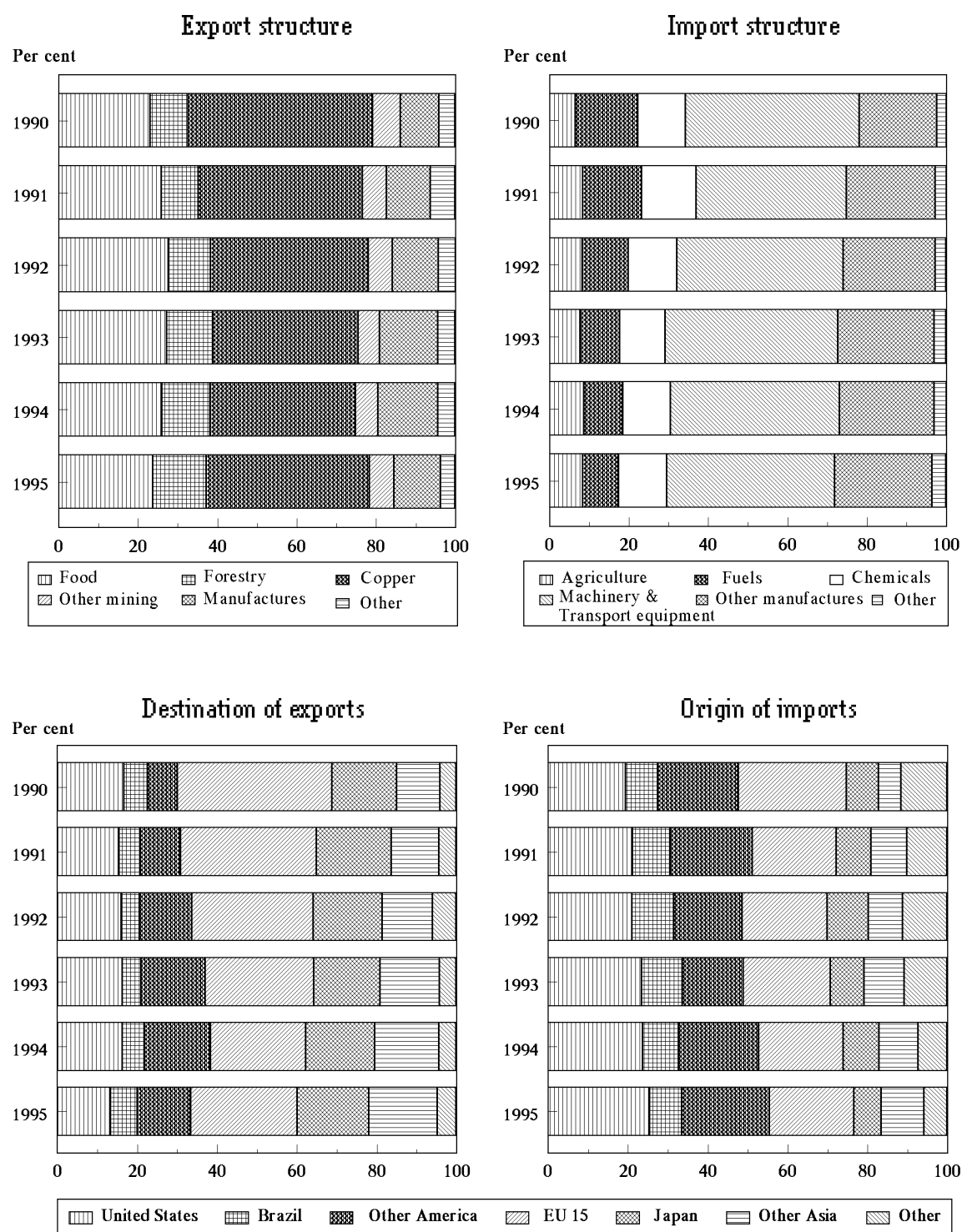
(4) Outlook

37. The authorities plan to continue the successful policies adopted since 1990, placing special emphasis on the further reduction of inflation, while accelerating growth, maintaining the stability of the exchange rate and the external accounts, and increasing investment in social areas. The Central Bank will continue the close management of interest rates to assist in achieving these goals. However, despite the expected decrease in interest rates, macroeconomic policy will still need to counter the effects of substantial capital inflows, as well as periodic fluctuations in government receipts and in the current account, linked to movements in world copper prices. Such inflows, and the policy response, have contributed to the gradual real appreciation of the *peso*, which, while helping to reduce inflation, seems to be a preoccupation for exporters. The proposed reduction in the uniform tariff should also help reduce inflation, and improve resource allocation.

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<sup>21</sup>East Asia includes Japan, Republic of Korea, Chinese Taipei, China, Indonesia and Thailand.

Chart I.7  
Composition and direction of trade, 1990-95



Source: UNSTAT, Comtrade database.