



## OXFORD ANALYTICA

CHILE

MONETARY TRANSPARENCY

Country Report 2006

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# CHILE



## COMPLIANCE RATINGS

<i>Monetary transparency</i>	2006	2005	2004	2003
Clarity of roles	●●●●	●●●●	●●●●	●●●●
Open decision process	●●●●	●●●●	●●●●	●●●●
Availability of information	●●●●	●●●●	●●●●	●●●●
Central bank accountability	●●●●	●●●●	●●●●	●●●●
<b>Score</b>	<b>4.75</b>	<b>4.50</b>	<b>4.50</b>	<b>4.25</b>

## OUTLOOK & COMMENTARY

Accountability, transparency and efficiency are sources of pride for the Central Bank of Chile (BCC). Its decision to make data on international reserves publicly available illustrates a willingness to further improve its information resources.

The new Fiscal Responsibility Law, approved in September 2006, authorises the central government to go forward with a recapitalisation of the BCC, thereby cancelling its debt to the Bank. Even though the transfers contemplated in the law are an optional scheme, there is widespread consensus that they will occur, so long as the current fiscal surpluses continue.

The government plans to take the necessary action in order to fully comply with the IMF Code of Good Transparency Practices for Monetary Policy in the near future. This includes providing a more detailed description of audit procedures, internal norms for procurement, and rules governing the ethical and personal conduct of staff.

## EXECUTIVE SUMMARY

### 4.75 Full Compliance

Transparency plays a key role in the conduct of central bank operations. The Central Bank of Chile (BCC) enjoys institutional independence and financial autonomy, with full discretion over monetary, financial, and foreign exchange instruments.

Central government debt with the BCC has been reduced in past years and currently amounts to approximately 1.55 billion US dollars. The new Fiscal Responsibility Law authorises the central government to transfer to the BCC up to 0.5% of GDP over a five-year period, starting in 2006. This recapitalisation of the BCC -- which will take place only so long as there is a budget surplus, and only once transfers have been made to a newly created *Pension Fund* -- is expected to strengthen its position before the market, thus allowing for the possibility of generating operating profits.

The BCC meets IMF Special Data Dissemination Standards requirements for monetary reporting. Recent central bank provisions have regrouped publicly available data on monetary aggregates and expanded the scope of disclosed information on financial instruments. A roadmap with detailed instructions for implementation of Basel II is publicly available, and targets are being met according to the schedule. Regular BCC board meetings with the Senate's finance committee fall into the general goal of keeping society informed about the macroeconomic policy debate, as well as ensuring that the central bank receives feedback on its policies.

BCC publications, together with information on international reserves, foreign debt, inflation and balance of payments are regularly posted and updated on the BCC's website. As of last year, the content of the *Annual Report* has been enhanced, and it has evolved into a genuine management report. In August 2006, the BCC institutionalised its unwritten practice of releasing the *Monetary Policy Report* and the *Financial Stability Report* within a pre-established timeframe. Additionally, a new annual *International Reserves Management Report* was published in September 2006, and it includes detailed information about the composition, structure, risk management, investment and liquidity portfolios of the country's international reserves.

The BCC's financial statements, detailing its revenues and expenditures, are published as part of the *Annual Report*, and are accompanied by an opinion from external auditors. A detailed description of the functioning of the internal audit unit is still pending, although progress has occurred in the past year.

Chile's overall score has improved from 4.50 in 2005 to 4.75.

## 1. CLARITY OF ROLES, RESPONSIBILITIES AND OBJECTIVES OF CENTRAL BANKS

●●●●● Full compliance

### The objectives and institutional framework of monetary policy

The Central Bank of Chile -- Banco Central de Chile (BCC)<sup>1</sup> -- is an autonomous institution governed by Chapter XII of the 1980 Constitution and the BCC Constitutional Organic Law.<sup>2</sup> The latter establishes specific provisions about central bank duties, including one to act in accordance with the general orientation of the government's economic policy.

#### Central bank objectives and responsibilities

The objectives of the BCC are clearly defined in Article 3 of the Organic Law, which requires the central bank to maintain currency stability and ensure the normal functioning of the system of internal and foreign payments. In addition, BCC objectives and responsibilities are clearly explained and commented upon in several publications, available on the central bank website. The BCC is responsible for regulating financial markets, international capital flows, and foreign exchange transactions. It also acts as fiscal agent and lender of last resort, and is responsible for the collection and publication of economic data. During 2006, legislative proposals to expand the scope of BCC objectives to include the promotion of economic growth have been repealed.

The BCC board determines foreign exchange policy and has the power to set limits and restrictions to foreign exchange transactions. In fact, although Chile operates a floating exchange rate regime, the central bank retains the right to intervene and place restrictions on foreign exchange operations. In practice, the floating exchange rate regime has allowed the economy to adjust smoothly to external shocks. A transparent policy framework and the lack of central bank interventions in the foreign exchange market, supported by fiscal prudence, have helped sustain competitiveness.<sup>3</sup> While the central bank is given clear responsibility for performing and regulating foreign exchange transactions, institutional responsibility for the choice of the exchange rate regime is not clearly defined. However, the BCC has exerted clear responsibility for setting the exchange rate regime.

The IMF has in the past suggested steps to avoid conflicts between price and exchange rate stability within the inflation targeting regime. Although the statutory definition of the monetary policy objective can be subject to different interpretations -- since currency stability may refer to internal (price) or external (exchange rate) stability -- Chilean authorities maintain that there is no need to clarify the institutional and exclusive responsibility for foreign exchange rate policy, already specified in the current legislation. Past modifications to the exchange rate regime have always been carried out with the participation of the Ministry of Finance (MoF) in line with pre-established regulations, announced to the public through the *Official Gazette* and reported to the Senate.

In late 2005, the BCC board created a Committee of Managers to draw up a medium-term strategic plan for the 2006-2008 period. Strategic planning is considered as key to directing and coordinating the efforts of all units towards accomplishing central bank objectives. This Committee is working towards defining the mission, vision and values of the Bank.<sup>4</sup>

#### Operational autonomy

The autonomy of the BCC is protected by the Constitution, which gives the central bank full authority to use monetary and exchange rate instruments, thus effectively shielding it from government intervention. Article 2 of the Constitution stipulates that the BCC is governed exclusively by the regulations of its own charter, together with certain specific provisions of the General Banking Act. Several judicial pronouncements have reaffirmed the BCC's independence from the government in the fulfilment of its duties.

In addition, Article 1 of the BCC's Organic Law grants the central bank financial, technical and administrative autonomy, which is strictly observed in practice. At present, there are very few concerns that fiscal policy may undermine the effective autonomy of the BCC.

Article 38 of the Organic Law authorises the BCC to keep, manage and use its international reserves, both within the country and abroad. The central bank also has the authority to pledge such reserves as security of compliance with its obligations. Evaluation and control of international reserves is conducted by the Management and Risk Evaluation Department, which reports directly to the Deputy General Manager, and its decisions are in turn supervised through BCC internal and external audit procedures. The BCC has requested advice from the Bank of England and the European Central Bank in order to strengthen its reserve management procedures.

## **Institutional relationship between monetary and fiscal operations**

The BCC carries out monetary policy without any interference from the government or other fiscal institutions. When passing a resolution, its board analyses the general orientation of government economic policies and may obtain any necessary information from other public institutions that might be needed to achieve proper implementation of monetary policy. The institutional relationship between monetary and fiscal operations is thus one of coordination, subject to the primacy of central bank objectives.<sup>5</sup>

### **Lending to government**

Article 98 of the Constitution limits the ability of the BCC to provide direct and/or indirect lending to the government, except in cases of emergency. In addition, Article 27 of the Organic Law states that the central bank can only grant financing or refinancing to banking entities and financial institutions, and prevents it from acquiring government debt, whether issued by the central government or any other government agency or state-owned enterprise. Exercising its emergency powers, introduced following the banking crisis of 1982-83, the BCC acquired government bonds from ailing financial institutions. Since 2005, substantial pre-payments of these liabilities have been carried out thanks to the large fiscal surplus attained and the government's commitment to meet the 2014 deadline to cancel out the debt.<sup>6</sup> Central government's debt with the BCC currently amounts to approximately 1.55 billion US dollars, down from 2.4 billion last year and 6.3 billion in 2001. Since the 1980s crisis, the BCC has not carried out any new lending operations with the government or purchased any government debt.

### **Central bank involvement in the rest of the economy**

The BCC Organic Law clearly defines regulations for central bank involvement in the rest of the economy. Article 35 gives the BCC authority to regulate financial markets and foreign exchange transactions. The central bank may also lend to private organisations and trade securities to ensure the stability of the financial and payments system. The procurement process is explained in the *Official Gazette*, where information on large contracts has to be published. Shortcomings in the disclosure of internal codes regarding acquisitions and procurement modalities remain and, although they are expected to be addressed in the future, no specific timetable for doing so has yet been prepared.<sup>7</sup>

### **Central bank profit allocation**

Section 5 of the BCC Organic Law defines the initial capital of the central bank and specifies that it may be increased by majority decision of the board through capitalisation of reserves, and adjusted by means of monetary correction. The majority of board members can request the MoF to increase the BCC's capital or make specific contributions to its assets on account of funds to be appropriated under the Budget Law. The Organic Law also establishes that profits for each fiscal year should be distributed annually, and Article 77 allocates up to 10% of the profits to central bank reserves. The remaining amount is transferred to the Treasury, unless a law allocates these resources in full or in part to the BCC's capital or reserves.

As mentioned above, after the banking crisis of 1982-83 the BCC purchased a substantial amount of public debt and other banking assets from ailing financial institutions, and these have led the central bank to incur losses of around 1% of GDP.<sup>8</sup> This liability results from the differences between interest payments and interest revenues derived from government debt servicing, since almost half of the loss originates from the government debt with the BCC. Within this context, in 2003, Congress authorised the BCC to change the denomination of the debt from dollars to Chilean pesos in an effort to align the structure of central bank credits and liabilities, but the change did not effectively take place.

Last year, the IMF called on the government to introduce an appropriate and transparent mechanism to cover the annual deficits of the central bank, in order to work toward its recapitalisation while preserving its institutional independence.<sup>9</sup> This capitalisation should also help resolve the BCC's ongoing quasi-fiscal deficit. The authorities acknowledge the importance of recapitalising the BCC so as to further consolidate confidence in the independence of monetary policy and allow for a better understanding of fiscal policy.

The Fiscal Responsibility Law (LRF) No. 20,128 -- approved in September this year -- authorises the central government to transfer to the BCC up to 0.5% of GDP over a five-year period, starting in 2006. This recapitalisation of the BCC -- which will take place only when the budget is in surplus and following transfers to a newly created *Pension Fund* -- is expected to strengthen its position before the market, thus allowing the possibility of generating operating profits. In 2008, the MoF will have to conduct an assessment of the impact of transfers on the BCC projected balance, with a 20-year timeframe. According to central bank officials, the BCC will not include transfers in its balance until they have effectively occurred, as Article 11 of the LRF does not impose a mandatory obligation on the government to carry out the recapitalisation.<sup>10</sup>

## **Agency roles performed by the central bank on behalf of the government**

The Constitution and Article 37 of the BCC Organic Law clearly define the agency roles performed by the BCC on behalf of the government. These include an advisory relationship on monetary, financial, and foreign exchange matters with the president of the republic. At the request of the MoF, the central bank may act as a fiscal agent in the issuing of government domestic and foreign debt. It may also represent the government in dealings with foreign financial and international organisations, including participation in international lending negotiations. It is also empowered to issue securities and place them abroad, as well as to grant credit to foreign states, central banks or international financiers. It may also accept deposits from the government and state-owned enterprises, with a majority approval from members of the board. Interest earned by these deposits may not be above market rates.

In 2003, Chile issued Law 19,913 in order to integrate and strengthen the legal and institutional framework to address anti-money laundering (AML) matters. The law is a substantial improvement on previous legislation: it updates the legal definition of the offence of money laundering, imposes AML reporting obligations on a wider range of institutions, and provides the legal basis for the creation of a Financial Analysis Unit (FAU) with authority to issue regulations and monitor compliance. The IMF has welcomed revisions to the legislation made in 2006 that enhance the FAU's ability to obtain information and more effectively combat money laundering. During the past

year, the FAU has been established and started operations.<sup>11</sup> While banking secrecy provisions continue to limit the ability of the country to investigate potential money laundering offences and to provide effective international cooperation, the FAU is empowered to request judicially the removal of banking secrecy as it applies to a specific investigation. Chile has recently received an official visit from the Financial Action Task Force of the South (GAFISUD), and a report on the country's practices is likely to be published during 2007.<sup>12</sup>

## 2. OPEN PROCESS FOR FORMULATING AND REPORTING MONETARY POLICY DECISIONS

●●●●● Full compliance

### The framework, instruments and targets of monetary policy

Since 2000, the BCC has used a standard forecast inflation targeting framework, within a flexible exchange rate regime. This framework has anchored inflation expectations and increased the economy's resilience to external shocks, maintaining price stability. Liquidity is managed through open market operations to maintain a stable overnight reference interest rate. Details of this framework are available on the central bank's website.<sup>13</sup> Any changes regarding monetary policy are widely published.

#### Framework and monetary targets

The main elements of the inflation-targeting framework in Chile consist of a pre-specified continuous inflation target band, a pre-announced 'policy horizon', and timely communication of the authorities' inflation forecast; in addition the rationale for policy decisions and the reasons for any temporary deviations from the inflation target are given.

The BCC uses a 3% annual inflation target, within a band of minus/plus 1%. Inflation is measured through changes in the Consumer Price Index (CPI) produced by the National Institute of Statistics (INE), although the monetary authorities focus their short-term analysis on a number of underlying CPIs. The INE produces an official figure for core inflation that limits seasonal price changes and short-term volatility.

A recent OECD report lays out possible options for the central bank policy agenda. With headline and expected inflation already safely anchored in the 2-4% target range, the BCC could consider the pros and cons of targeting core, rather than headline, inflation and the associated adjustments to the width of the target band. However, the BCC is against these proposals and believes that the current framework represents a clearer and more user-friendly system than targeting core inflation.<sup>14</sup>

The BCC uses a two-year forecast horizon for projecting inflation, with medium-to-long-term deviations of inflation from the target triggering policy shifts. The BCC conducts monetary policy through a reference overnight interest rate compatible with the inflation target. Interventions are aimed at maintaining the stability of the reference rate.

Chile has had a flexible exchange rate since 1999, and free capital flows since April 2001. The exchange rate policy calls for zero intervention, but allows for the possibility of conducting foreign exchange operations under exceptional circumstances, such as episodes of considerable volatility that the BCC board estimates to be outside market trends. Alongside the adoption of a floating exchange rate regime, the BCC committed itself in 1999 to a framework for the communication of the time span, size, and justification of its foreign exchange interventions. Since then, interventions have occurred only twice, coinciding with regional financial turbulence.<sup>15</sup>

According to the IMF, the floating exchange rate regime has benefited the economy and allowed it to adjust smoothly to external shocks. They commended the BCC's transparent policy framework, with few interventions in the foreign exchange market.<sup>16</sup>

### **Monetary instruments**

The BCC conducts open market operations using an electronic auction system. Since August 2001, it has used a nominal interest rate (instead of a real interest rate) as the reference rate in its open market operations. This reflects the low inflation achieved, while discouraging the indexation of other contracts in the economy, especially to the short end of the yield curve. The BCC also requires financial institutions to meet mandatory overnight deposits of 9% and medium-term deposits of 3.6%.

### **The monetary policy-making body**

Article 6 of the BCC Organic Law grants authority to conduct monetary policy to the board of the BCC.

### **Monetary board**

Articles 6 to 21 of the BCC's Organic Law establish the composition, structure and functions of the central bank's board. The board has five members, appointed by the president of the republic with the approval of a majority of the Senate. Members of the board are appointed for 10-year terms and are eligible for reappointment.<sup>17</sup> Approval of board resolutions requires a minimum attendance of three members, unless a special quorum is required by the law, given the importance and impact of a specific subject. The president of the BCC is the president of its board and is appointed by the president of the republic from among board members. The minister of finance is not a board member, but is authorised by the Organic Law to attend its meetings, with the right to speak but not to vote.<sup>18</sup> He can suspend the application of board resolutions not taken by unanimity, for a maximum of fifteen days, and may in that time ask the BCC president to call for an extraordinary board meeting to review the decision.

Explicit legislative provisions strengthen independence of board members from short-term political pressures and allow them to give greater weight to price stability. The president of the republic, with justified reason and prior approval of the Senate, may remove any or all of the board members. The dismissal may only be based upon the grounds that the concerned member has voted in favour of resolutions representing a clear breach of the purposes of the BCC as specified in its Organic Law, and that those resolutions have been the direct cause of material damage to the economy of the country.

An organisational chart, including board members, the general manager, general counsel and division managers is published on the central bank website.

### **Advance meeting schedule**

The BCC's website includes a six-month advance meeting schedule for monetary policy board meetings. The board holds ordinary sessions once a month. The BCC lists dates of all board meetings since 1997, in addition to details of forthcoming meetings. It also provides minutes of the meetings, giving a concise outline of the rationale underpinning monetary policy decisions. Decisions pursuant to the deliberations of the monetary policy board come into effect with the publication of the relevant resolution in the *Official Gazette*. Agreements adopted by the board are available online.<sup>19</sup>

### **Public statements on monetary policy**

Central bank authorities publish tri-annual *Monetary Policy Reports (Informes de Política Monetaria)* that review recent domestic and foreign economic developments, as well as the state of the foreign exchange and financial markets, and present medium-term growth and inflation forecasts. These reports also explain the policies carried out

by the BCC to meet its inflation target over a two-year period, explicitly describing inflationary risk scenarios. The September report coincides with the constitutionally mandated annual report to the Senate, which reviews and describes the policies and interventions undertaken by the BCC and includes a detailed analysis of the state of the national economy. The *Monetary Policy Report* usually includes a section on the explicit rationale for recent monetary policy decisions.

The BCC's *Annual Report* -- which has been published in English as well as Spanish since 1983 -- contains a full explanation of the main BCC operations, including monetary policy, financial policy, foreign exchange policy, related external audits, administrative measures, a description of past macroeconomic developments, and research and development activities. Information on the international outlook, balance of payments, international reserves, foreign debt, inflation and wages is also included in this report. The content of the annual report was enhanced for the 2005 edition, helping it to evolve into a genuine management report. Models used by the BCC to prepare its forecasts are publicly available.<sup>20</sup>

Since 2005, the quality and timeliness of information disclosed by the BCC have improved. A press release is now made available at the end of each meeting, underlying the main decisions taken. In addition, minutes of the board meetings reflecting different members' positions are released with a three-week lag, together with the *Background Information Report* that contains detailed analysis, forecasts, and statistical information.<sup>21</sup> The underlying principle is that board decisions should be taken using the same information available to the market. Even though publicly available information on BCC board meetings is considered of high quality, a public debate on the convenience of disclosing opinions of individual board members in the minutes is currently ongoing. At present, these opinions are recorded in the transcripts of the meetings but are not publicly released.<sup>22</sup> Information on board meetings is available on the BCC's website.<sup>23</sup> The website also includes speeches and documents drafted by board members explaining policy decisions implemented during the year.

### **Periodic publications**

Market participants have praised the timeliness and reliability of information provided by the BCC, both in Spanish and in English. Under central bank agreement No. 1289 of August 2006, the *Monetary Policy Report*, the *Financial Stability Report*, the *International Reserves Management Report* and BCC progress reports on its balance sheet are all part of the mandatory information that has to be submitted periodically to the presidency, the Senate, and the general public, within a pre-established time framework.<sup>24</sup> The BCC agreement mandates previous unwritten practice -- with the exception of the newly created *International Reserves Management Report* and BCC progress reports on its balance sheet -- and it is intended to reinforce central bank transparency.

The *Monetary Policy Report* is published in January, May, and September and, like the BCC annual reports, reviews monetary policy and inflationary risks.<sup>25</sup> The quality of this report, which includes forecasting analysis and data, is widely recognised.

The *Monthly Report* contains general economic information as well as a review of monetary aggregates, international reserves, and other macroeconomic data. This report is published on the 23rd of each month, and includes analysis of balance of payments, copper price, imports and exports, GDP, the BCC's monetary programme, international reserves, financial services, external debt, and BCC presentations and financial circulars issued during the assessed period. The *Monthly Report* also includes a detailed description of the statistical information provided. In addition, the *Monthly Progress Statistical Report*, published on the seventh of each month, includes information on the international economy, monetary base and aggregates, economic activity, expenditure and statistics. The *Daily News* contains monetary and foreign exchange information.<sup>26</sup>

Since 2004, the BCC has published a *Financial Stability Report* twice a year that includes national and international macroeconomic and financial information; a progress report on foreign debt; the position of the non-banking financial institutions; and an overall assessment of the Chilean financial position. This publication is more analytical than statistical and has been envisaged to complement the statistical information already available.

The BCC's Book Series on *Central Banking, Analysis, and Economic Policies* is available online. This series publishes new research on central banking and economics in general, with special emphasis on issues and fields that are relevant to economic policies in developing economies. Policy usefulness, high-quality research, and relevance to Chile are the main criteria for publishing books. The *Working Paper Series* of the BCC disseminates economic research conducted by central bank staff or third parties under its sponsorship. The purpose of the series is to contribute to the discussion of relevant issues and develop new analytical or empirical approaches in their analysis.

The BCC carries out a survey of economic expectations among research institutions and independent experts. A number of publications covering developments on national statistics (such as *National Accounts, Balance of Payments and External Debt*) are also available online. In addition, the BCC issues weekly press releases with economic information, such as monetary aggregates and trade data.<sup>27</sup>

### **Public hearings**

Articles 66 to 74 of the Organic Law contain provisions for the publication of BCC decisions and appeal procedures. The central bank has an online service for receiving comments on new norms and regulations that are under discussion. This complements online availability of relevant documents and questionnaires. The system has been successfully used for issues like the implementation of a new payments system and real-time settlement of large transactions, as well as new regulations referring to liquidity. In the past year, the system was used to test the release of new monthly information on the BCC's balance sheet.

### **Regulations on data reporting by financial institutions to the central bank**

Article 35 of the Organic Law requires that financial institutions disclose information to the BCC, which is responsible for regulating the financial system and the capital market and can dictate norms and conditions to banking and financial institutions. The regulatory framework and operating guidelines for the central bank's counterparts in the financial sector are publicly available on the website.

Responsibility for inspecting financial institutions lies with the Superintendence of Banks and Financial Institutions (SBIF), whose activities and operational mandate are clearly established.<sup>28</sup> Detailed and up to date information on financial institutions is publicly available through the SBIF website, which has continued improving the quality and timeliness of its content in the past year, including the release of a *1990-2005 Banking System Report*, the monthly *Financial Information Report*, and a more detailed report on financial instruments. The SBIF has recently launched an *Easy Banking* website, in order to allow for a clear understanding of the financial system by outside market participants.<sup>29</sup>

Chile's banking industry and its regulatory authorities have been looking closely at the implications of the new recommendations introduced by the International Convergence of Capital Measurement and Capital Standards (known as Basel II). Commentators have suggested that Chile is well positioned to move into line with the new accord and will do so at the pace that best suits its own interests. A roadmap with detailed instructions for implementing Basel II is publicly available. Targets are being met according to schedule, including a stress-testing exercise of the financial system and an assessment of the Chilean banking system's capital adequacy under different scenarios. Results indicate that the banking system would maintain satisfactory indicators in the case of hypothetical interest-rate, exchange-rate and credit-risk crises. Additionally, an individual stress-testing stage of each financial

institution is currently being undertaken.<sup>30</sup> The alignment of accounting standards continues to progress. In the past year, individual opinions from institutions have been collected and are currently being discussed in a specifically created committee. Implementation is likely to start once a consensus is reached. According to the current timeframe, the new accounting methodology is likely to be adopted throughout the entire financial system by 2009.<sup>31</sup>

Although implementation of Basel II will require the amendment of the General Banking Law, the SBIF intends to begin working in close collaboration with financial institutions before the actual congressional approval of amendments. At present, the SBIF's objective is to ensure that financial institutions operate within a homogeneous system. Gradual implementation of Basel II is expected to reduce capital requirements in the short term. Capital adequacy ratios are expected to remain high.<sup>32</sup>

The BCC has continued making progress in the modernisation of financial regulations and methods used by financial institutions to manage liquidity risk. This project started in late 2004 and has developed with the creation of a risk value map, a treatment plan and a monitoring and reporting system. A review of rules governing market risk was concluded in January 2005 with the publication of new regulations for identifying, monitoring and controlling risk.<sup>33</sup> These rules only came into force in July 2005 to grant banks a period to adapt their market risk management systems to the new regulations. The new regulations allow for better identification, measurement and control of interest rates and currency risks. This new framework incorporates international standards and recommendations, and allows the quantification of risk associated with maintaining open positions on options. It also limits the exposure of available capital once the charges associated with credit risk are deducted.

The 'Real Time Gross Settlement System,' established in early 2004, worked faultlessly in the past year. A Real Time Gross Settlement System Supervisory Committee was created in order to supervise the progress of the system.<sup>34</sup> This scheme governs the transfer of funds in Chilean currency, individually and continually, with participating banks issuing instructions to transfer as soon as they have the necessary resources in their peso checking account at the BCC. The system, which has reduced risks and improved timeliness of information, is administered by the BCC and used by every established banking firm in the country. During 2006, the BCC and the SBIF have coordinated an exercise among financial institutions to assess the functioning of the system.

Approval of the Capital Markets II (MK2) draft law should further enhance efficiency of the financial system and its oversight. An updated version of the law is currently being discussed in Congress and is likely to be approved in the near future.

### 3. PUBLIC AVAILABILITY OF INFORMATION ON MONETARY POLICY

●●●●● Full compliance

#### Release of central bank data

Chile subscribes to the IMF Special Data Dissemination Standard (SDDS) and meets its requirements for the release of a wide range of monetary information.<sup>35</sup> Article 53 of the BCC Organic Law requires the central bank to compile and publish in a timely fashion the main national statistics, including monetary and exchange statistics, the balance of payments, and the national debt, as well as other general economic and social indicators. The data cover domestic and international lending, both to the private sector and publicly owned entities, and are praised for their high reliability. Liabilities are broken down into money, currency reserves and promissory notes.

In May 2006, the BCC board changed internal regulations about its main macroeconomic statistics, in line with the recommendations of international financial institutions.<sup>36</sup> New provisions have regrouped monetary aggregates such as the monetary base and international reserves -- including an efficient reduction of them -- and extended the disclosure of information of financial instruments.

The *Daily News* and *Monthly Report* publications provide detailed information on BCC operations. These include regulations, open market operations, foreign exchange interventions, net and gross reserve levels, lender of last resort operations, monetary aggregates, and trade data. An advance release calendar that identifies precise release dates three months in advance is published on the BCC's website.<sup>37</sup> The calendar is updated at least once a month and follows SDDS procedures. The BCC website contains a calendar of economic events that records not only monetary policy information but also general economic information such as CPI and employment statistics.<sup>38</sup> The BCC provides access to details of its open market operations.<sup>39</sup> The BCC's *Monthly Indicator of Economic Activity* (IMACEC) is now published with a lag of 35 days, down from 53 days in 2005. In addition, comprehensive information is published as regards different indicators of the behaviour of domestic prices.

#### The central bank balance sheet

The BCC publishes an annual balance sheet and an annual income statement. Prior to 31 January of each year, the General Manager has to submit to the board the financial statements for the preceding fiscal year. The annual BCC financial statement is also submitted to the Ministry of Finance and the Senate prior to 30 April of each year. Financial statements have to be submitted with an opinion issued by external auditors appointed by the board from among those auditors registered with the SBIF.<sup>40</sup> They are published, together with auditors' notes and opinions, in the *Official Gazette* and in a newspaper of national circulation. The BCC also releases monthly balance sheets with detailed information about outstanding liabilities and assets. Since last year, a progress report on the BCC's balance sheet has been published within the *Monthly Report*.

#### Lender of last resort

Article 36 of the Organic Law allows the central bank to carry out lender of last resort operations to financial institutions, with the exception of state-owned enterprises. Operations of this type may extend for up to ninety days. After that, loans can only be renewed with the agreement of a majority of the board. These decisions are subject to a report from the SBIF. The BCC may lend to state-owned enterprises and the government only under a state of

emergency clause. All lender of last resort operations are disclosed in press releases, the *Daily News*, and BCC income statements. Details of outstanding loans are available in the BCC balance sheets.

## Public information services

The central bank maintains good public information services and has continued to improve the quality and amount of information publicly available on its website, covering both statistical data and analysis of monetary policy. The process to further increase BCC transparency and accountability is continuously ongoing. The Communications Department, established in 2004, has enhanced the central bank's relationship with the press and market participants, ensuring timely and fair distribution of information. Since the establishment of this department, contacts of BCC officials with the press have been reduced, and leakages of information have virtually disappeared. Press releases are posted on the BCC website. In late 2005, the Deputy General Manager's office was created, with Communications, Information Systems, Human Resources and International Relations reporting directly to it.

In addition to the abovementioned periodic publications, the BCC releases and publishes online a wide variety of documents and occasional publications, including *Central Bank Economic Policy Documents*, *Central Bank Working Papers*, and the *Chilean Economy Magazine*, that provide in-depth analysis of economic and financial policy. The *Annual Report* and the *Monetary Policy Reports* are available in English. Regulations, circular letters, and resolutions are also available. Details of resolutions must be published within five days of their adoption.

The *Chilean External Debt Report* provides information on medium-term and long-term foreign debt on an annual basis, broken down by public and private sector. It also provides data on short-term foreign debt. The information covers different classifications and refers to balances owed as of specific dates or annual movements (in-flows and out-flows of foreign credits) and projections for servicing the debt itself.

Information about the BCC's international reserves is publicly available through its website, and the BCC releases detailed figures indicating how international reserves are managed.<sup>41</sup> Since 2004, it has included an explanation of how to read the data provided and, since 2005, information on international reserves has been institutionalised by the BCC board and compiled into the *International Reserves Management Report*.<sup>42</sup> This annual report, first published in September 2006, includes detailed information about the composition, structure, risk management, investment and liquidity portfolios of the country's international reserves, together with detailed figures on the amount of international reserves and revenues generated from their management. The 2006 report also includes the institutional framework used by the BCC to manage international reserves. Starting in 2007, this new report will be included as an annex to the BCC's *Annual Report*. The progress of the BCC regarding public availability of information about its international reserves has consolidated previous practices in line with the IMF's 'Guidelines for Foreign Exchange Reserve Management' and has been highly praised by commentators.<sup>43</sup>

The BCC issues reliable newsletters, providing information on current economic indicators and releases of publications and dissertations. The service is available through free subscription, both in Spanish and English. Following the leakage of sensitive information in 2003, the BCC has stepped up security, and has reduced the amount of time during which it holds market sensitive information before publishing it. Procedures to manage sensitive information have been improved in various ways, including the reduction of time lags in the publication of relevant information for market participants, the use of more advanced technological procedures to protect privacy, and the modernisation of certain practices and regulations involving transactions and custody of securities in secondary markets.

## 4. ACCOUNTABILITY AND ASSURANCES OF INTEGRITY BY THE CENTRAL BANK

●●●● Compliance in progress

### Accountability before a designated public authority

The BCC prepares a report which provides information on the execution of policies and programmes carried out during the previous year, as well as financial statements. The report, which includes a detailed analysis of the situation of the national economy, complemented by a statistical appendix, can be accessed by the public at the BCC's offices and is also submitted to the minister of finance and the Senate prior to 30 April of each year. Regular BCC board meetings with the Senate's finance committee fall into the general goal of keeping society informed about the macroeconomic policy debate, as well as ensuring that the central bank receives feedback on its policies. Although it has improved in the past few years, some commentators have suggested that the Senate's technical capacity should be further strengthened in order to increase its supervisory role.<sup>44</sup>

There is a legal requirement for the BCC board to submit to the minister of finance and the Senate, prior to 30 September of each year, an evaluation of progress made in implementing policies and programmes for the current year. This statement accompanies a report on the proposed policies and programmes for the next calendar year, and includes general economic projections and their possible effect on the financial statements for the following year. Beyond this legal requirement, the BCC has been submitting reports on evaluation of progress of its policies on a quarterly basis. Although the BCC is only required to provide information on its policies, in practice it also provides extensive explanations justifying the appropriateness of its policy decisions.

Following the board meeting in August 2006, the submission of monetary policy information to the president of the republic and the Senate has become part of the BCC's institutional policy. In addition, BCC agreements relating to international reserves, liquidity, and progress on its balance sheet also have to be presented to the executive and the legislative branches.

### Financial statement

The BCC's financial statements, detailing revenues and expenditures of the BCC, are published annually as part of the *Annual Report*, and are accompanied by an opinion from external auditors.

#### Audited financial statement

The central bank's General Manager must produce the financial statement by 31 January of the next fiscal year. Subsequently, an auditing firm carries out the statement's external audit.

#### External and internal audit

The BCC General Auditor is responsible for the control and internal supervision of the central bank's accounts, operations and administrative regulations. The General Auditor must report -- in writing to the president of the board, with a copy to the rest of its members, -- the comments and objections he may deem appropriate regarding accounts and operations.<sup>45</sup> Once reviewed by the General Manager, these internally audited statements are sent to external auditors designated by the BCC's board. In 2005, the role of the General Auditor was reinforced to become

more proactive in the areas of risk management, internal monitoring and corporate governance. In order to strengthen internal audit procedures, the BCC has recruited trained staff and has appointed a Chief Auditor to whom the General Auditor now has to report. The Chief Auditor reports directly to the BCC's board. A description of the functioning of the internal audit unit is still pending, although some information has been included in the 2005 *Annual Report*.

A firm registered with the SBIF carries out the external audit of central bank accounts. External audit for 2005 was conducted by Ernst & Young Ltd. Financial statements of the BCC are released according to the procedures approved by its board, which also need to be agreed by the SBIF. The financial statements contain a summary of significant accounting principles and notes from the auditors.

## Conduct of officials

The Organic Law of the BCC governs the code of conduct of employees, including its board. It comprises an extensive list of activities deemed incompatible with the role of board membership, and general staff conduct regulations. Board members are precluded from intervening or voting on resolutions in which they may have a commercial interest. The law also establishes that board members are under no obligation to appear in court, with the limitations provided in the codes of civil and criminal procedures.<sup>46</sup> In 2002, Congress modified the Organic Law to prevent board members from having equity or ownership of financial institutions. As such, before taking office, board members are required to declare their interests under oath. Following the Inverlink incident -- where financial documents worth over 100 million US dollars were stolen by the local financial group, Inverlink<sup>47</sup> -- in 2003 the BCC issued a document on *Ethical Standards and Secure Information* that its officials now have to follow.<sup>48</sup>

The 2005 *Annual Report* includes a section on Institutional Management and Governance, addressing previous shortcomings on the availability of this information. However, public availability of procurement procedures, and of norms governing the ethical and personal conduct of staff, is still weak. In addition, the IMF has recommended the online publication of a note on internal rules regarding the personal financial affairs of the staff.<sup>49</sup>

Efforts to introduce new management techniques that enhance efficiency in the use of resources, minimise and manage financial and operating risk, and keep up with international standards for transparency and reputation are under way. In late 2005, the BCC's International Division was eliminated and the Financial Operations Division (FOD) was created, in order to help the BCC give greater emphasis to capital markets. The FOD is responsible for interactions with domestic and international financial markets to implement monetary policy, and it administers international reserves.

The Research Division and the Financial Policy Division focus on analysis in the macroeconomic and financial fields respectively. In order to further strengthen analytical work and to ensure the stability of domestic and external payments, a Financial Stability Management area was created within the Financial Policy Division during 2005. Organisational changes follow the best practices observed in other central banks around the world. The BCC has also incorporated best practices in corporate governance into its internal management, through the creation of different committees -- including a Management Committee, a Technology Committee, an Investment Committee, and a Statistics Committee.

Preferential development of human resources, transparency in budgetary management, and support for clear ethical rules, together with priority for identifying and controlling the risks inherent in BCC functions and responsibility, are among the most relevant guidelines provided by the central bank.<sup>50</sup>

## INTERVIEWS

Representatives of *Oxford Analytica* interviewed the following individuals during a visit to Chile between 16 and 18 October 2006:

### Central Bank of Chile

#### 16 October 2006

Rodrigo Valdes Pulido	General Manager	Department of Economic Research
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### Ministry of Finance

#### 18 October 2006

Jorge Rodríguez Cabello	Head, Research Division	National Budget Office
Matías Bernier Bórquez	Head, Financial Planning	National Budget Office
Leticia Celador Izquierdo	Legal Advisor	Capital Markets & International Finance Department
William Mullins	Advisor	Capital Markets & International Finance Department

## ADDITIONAL INTERVIEWS

#### 17 October 2006

Christian Howard	Studies Division	Superintendence of Securities and Insurance
Felipe Morandé	Dean	University of Chile – Faculty of Economics
Mariana Schkolnik	Director	National Institute of Statistics (INE)
José Inostroza Lara	Advisor	National Institute of Statistics (INE)
Gustavo Arriagada	Superintendent	Superintendence of Banks & Financial Institutions
Fernando Valdes Ossa	Correspondent	Superintendence of Banks & Financial Institutions
Axel Buchheister Rosas	Legislative Programme Director	Freedom and Development Institute
Rosanna Costa	Economic Programme Director	Freedom and Development Institute

#### 18 October 2006

Leonardo Suarez	Chief Economist	Larrain Vial Consulting
Diego Figueroa Martinez	Economist	Larrain Vial Consulting

## NOTES

<sup>1</sup> The Central Bank of Chile (Banco Central de Chile) at: [www.bcentral.cl](http://www.bcentral.cl)

<sup>2</sup> Constitution of Chile of 1980, last amended in 2005 at: [www.bcn.cl](http://www.bcn.cl); Organic Law of the Central Bank of Chile at: [www.bcentral.cl/eng/funorg/organiclaw/](http://www.bcentral.cl/eng/funorg/organiclaw/)

<sup>3</sup> 'IMF Executive Board Concludes 2006 Article IV Consultation with Chile', IMF Public Information Notice 06/97, August 2006, available at: [www.imf.org](http://www.imf.org)

<sup>4</sup> Information about the strategic planning process is available at: [www.bcentral.cl/eng/funorg/plann/](http://www.bcentral.cl/eng/funorg/plann/)

<sup>5</sup> 'Chile: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation', Country Report No.04/269, August 2004, available at: [www.imf.org](http://www.imf.org)

<sup>6</sup> In 2005, prepayments were done in Chilean pesos. However, during 2006, prepayments have been performed in US dollars. In 2014, the debt of the government with the central bank is likely to be cancelled. However, the BCC's recapitalisation process will not be completed until 2026 at the earliest.

<sup>7</sup> Interviews in Chile, 16-18 October 2006.

<sup>8</sup> The total amount of BCC debt up to the end of the second quarter of 2006 represented 13.6% of the country's GDP, down from 29% in 2002. The reduction has occurred thanks to central government pre-payments and a decrease in BCC reserves. The latter have decreased in order to pay debt derived from BCC's unnecessary market interventions.

<sup>9</sup> 'IMF Executive Board Concludes 2005 Article IV Consultation with Chile', IMF Public Information Notice 05/104, August 2005, available at: [www.imf.org](http://www.imf.org)

<sup>10</sup> Even though the recapitalisation process of the BCC is optional for the government, there is widespread consensus that it will effectively take place so long as the current fiscal surplus continues.

<sup>11</sup> According to Law 19,913, the Financial Analysis Unit is a decentralised public service agency attached to the Ministry of Finance whose mission is to prevent the financial system and other sectors of economic activity from being used to commit money laundering offences. Law 20,119 of August 2006 has strengthened FAU's powers.

<sup>12</sup> GAFISUD is a regional inter-governmental organisation that brings together the countries of South America in order to combat money laundering and terrorism financing by means of the continuous improvement of national policies and the strengthening of different methods of cooperation between Member States.

<sup>13</sup> Monetary Policy of the Central Bank of Chile: Objectives and Transmission Mechanism at:

[www.bcentral.cl/eng/stdpub/publications](http://www.bcentral.cl/eng/stdpub/publications)

<sup>14</sup> Interviews in Chile, 16-18 October 2006.

<sup>15</sup> The latest BCC intervention occurred in 2002, as a consequence of regional instability. The central bank announced a temporary window of exchange market intervention that was, in practice, less than the announced limits.

<sup>16</sup> 'IMF Executive Board Concludes 2005 Article IV Consultation with Chile', IMF Public Information Notice 05/104, August 2005, available at: [www.imf.org](http://www.imf.org)

<sup>17</sup> Article 8 of the Organic Law of the BCC discusses the term of the members and establishes limits for their replacement, allowing for one member to be changed every two years.

<sup>18</sup> The minister also has the right to propose agenda items or specific policy decisions (such as monetary policy, foreign exchange, and financial regulation) for discussion.

<sup>19</sup> Available at: [www.bcentral.cl/esp/normativa/acuerdos/](http://www.bcentral.cl/esp/normativa/acuerdos/)

<sup>20</sup> *Macroeconomic Models and Central Bank Projections 2003 (Modelos Macroeconómicos y Proyecciones del Banco Central de Chile 2003)*, December 2003, available at: [www.bcentral.cl/esp/publ/indexper.htm](http://www.bcentral.cl/esp/publ/indexper.htm)

<sup>21</sup> The *Background Information Report* first appeared in July 2005, and is available every month except January, May and September, when the *Monetary Policy Report* is published.

<sup>22</sup> Those in favour of the disclosure of individual opinions argue that it could increase transparency. Commentators against the disclosure of individual opinions maintain that it could damage the technical analysis of the BCC, restrict the expression of opinion by participants, and transform board views into a political issue.

<sup>23</sup> Information on BCC board meetings is available at [www.bcentral.cl/esp/politicas/reunionespolitica/](http://www.bcentral.cl/esp/politicas/reunionespolitica/)

<sup>24</sup> This is in line with the 2005 amendment to the National Constitution, which now states in its Article 8 that acts of public institutions are public and their underlying principles should be made publicly available.

<sup>25</sup> *Annual Reports* and *Monetary Policy Reports*, publicly available at: [www.bcentral.cl/eng/stdpub/publications](http://www.bcentral.cl/eng/stdpub/publications)

<sup>26</sup> A list of publicly available publications, including the *Monthly Report (Boletín Mensual)*, the *Financial Stability Report (Informe de Estabilidad Financiera)*, *Monthly Progress Statistical Report (Avance estadístico del Boletín Mensual)* and *Daily News (Informativo Diario)*, is available at: [www.bcentral.cl/esp/publ/indextema.htm](http://www.bcentral.cl/esp/publ/indextema.htm)

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<sup>27</sup> Available at: [www.bcentral.cl/esp/infoeconomica/coyuntura/](http://www.bcentral.cl/esp/infoeconomica/coyuntura/)

<sup>28</sup> See the Superintendence of Banks and Financial Institutions (*Superintendencia de Bancos e Instituciones Financieras*) website at: [www.sbif.cl](http://www.sbif.cl)

<sup>29</sup> *Easy Banking* website, available at: [www.bancafacil.cl](http://www.bancafacil.cl)

<sup>30</sup> 'Directrices de la Hoja de Ruta para la Transición hacia Basilea II', January 2005, available at: [www.sbif.cl/sbifweb/internet/archivos/publicacion\\_2723.pdf](http://www.sbif.cl/sbifweb/internet/archivos/publicacion_2723.pdf)

<sup>31</sup> Interviews in Chile, 16-18 October 2006.

<sup>32</sup> 'Improving the Banking System: The Chilean Experience', Economic Policy Papers No.16, Central Bank of Chile, March 2006.

<sup>33</sup> This new approach is based on the Basel Committee's Recommendations of 1996, and recommendations from 2004 on managing interest rate risk, which are an integral part of considerations included in Basel II.

<sup>34</sup> The General Manager chairs the monthly meetings, which include the managers of the Financial Operations and Financial Policy Divisions, a representative from the General Auditor's office, the managers of Domestic Financial Markets, Infrastructure and Financial Regulation, Information Systems, and the head of the Department of Payments and Securities.

<sup>35</sup> IMF Special Data Dissemination Standards (SDDS) – Chile, at: <http://dsbb.imf.org/Applications/web/sddsnsdppage/>

<sup>36</sup> The decision was adopted by Agreement N° 1267-04-060518 of the BCC board.

<sup>37</sup> Available at: [www.bcentral.cl/esp/infoeconomica/fminedd/calendarioestadisticas/index.htm](http://www.bcentral.cl/esp/infoeconomica/fminedd/calendarioestadisticas/index.htm)

<sup>38</sup> Available at: <http://www.bcentral.cl/esp/infoeconomica/calendario/2006/01.htm>

<sup>39</sup> BCC Open Market Operations, available at: [www.bcentral.cl/esp/oma/](http://www.bcentral.cl/esp/oma/)

<sup>40</sup> Article 76, the Organic Law of the BCC.

<sup>41</sup> Available at: [www.bcentral.cl/esp/infoeconomica/fminedd/liquidez\\_intl/index.htm](http://www.bcentral.cl/esp/infoeconomica/fminedd/liquidez_intl/index.htm)

<sup>42</sup> Available at: [www.bcentral.cl/esp/opfin/resint/](http://www.bcentral.cl/esp/opfin/resint/)

<sup>43</sup> Interviews in Chile, 16-18 October 2006.

<sup>44</sup> Interviews in Chile, 16-18 October 2006.

<sup>45</sup> Article 26, the Organic Law of the BCC.

<sup>46</sup> Article 21, the Organic Law of the BCC.

<sup>47</sup> The incident has not only damaged market confidence, but also undermined the government's credibility. Pressure on the BCC president to stand down succeeded. As a result, the BCC has stepped up security, but has also reduced the time it holds market sensitive information before publishing it.

<sup>48</sup> Available at: [www.bcentral.cl/esp/politicas/exposiciones/miembroconsejo/pdf/2003/informe%20seguridad.pdf](http://www.bcentral.cl/esp/politicas/exposiciones/miembroconsejo/pdf/2003/informe%20seguridad.pdf)

<sup>49</sup> 'Chile – Financial Sector Assessment Program. Detailed Assessment of Observance of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies', IMF Country Report No. 04/326, October 2004.

<sup>50</sup> Interviews in Chile, 16-18 October 2006.