The Chilean economy: Institutional buildup and perspectives

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Outline

1. Introduction
2. Chile’s economic reforms and institutional buildup
3. Performance of the Chilean economy
4. Conclusions
1. Introduction
Introduction

- Chile has shown outstanding economic performance during the past twenty years.
- Average growth in the last two decades was 5.9% and projections for 2007 range between 5%-6%.
- Inflation has declined steadily, approaching developed-country levels.
- These results have been achieved within an economic model based on macroeconomic stability, strong institutional settings, robust financial sector, competitive open markets and a comprehensive social network.
2. Chile’s economic reforms and institutional buildup
Period up to the 1970s

- In the early 1970s, the Chilean economy was closed to international trade, suffered from widespread price controls, a high degree of state intervention and severe macroeconomic imbalances:
  - Fiscal deficit around 30% of GDP;
  - Annual inflation rate above 500%;
  - Average import tariff of 105% (with great dispersion), multiple exchange rates and many other restrictions to international trade (e.g., quotas);
  - Price and interest-rate controls.
In the 1970s, Chile initiated its economic transformation that continues to this day.

First-generation reforms included:

- Fiscal adjustment: VAT was introduced in 1975 and fiscal surplus reached in 1976;
- Trade reform: non-tariff barriers were lifted and tariffs cut unilaterally to a flat 10% in 1979;
- Privatization: State-owned enterprises and banks were privatized or returned to previous owners.
Furthermore

- Previously controlled prices and interest rates were liberalized;
  - Capital account restrictions were partly lifted while exchange rates were unified;
  - Restrictions to banks and other intermediaries began to be removed.
- In 1981, Chile carried out a major reform to the social security system.
1982-83 crisis

- Stabilizing and market-oriented policies allowed quick growth. However, some weaknesses emerged.
- The fixed exchange rate combined with weak regulatory and supervisory frameworks of the banking system exacerbated moral hazard and fragility in the banking industry.
- The sharp external shock (i.e. the increase in world interest rates and the dollar appreciation of the early 1980s) was all it took to unleash a profound macroeconomic and financial crisis.
Reforms

- The 1982-83 crisis uncovered major regulatory shortcomings and triggered in 1986 a revision of several institutions. In particular, second-generation reforms included:
  - New banking and bankruptcy laws;
  - The Central Bank being granted full autonomy and precluded by law from financing the government (1989).
- In 1989, a successful transition to democracy began, maintaining and strengthening the already thriving market economy model.
- Since then, additional weight has been given to social policies as a way to build social cohesion and accelerating poverty alleviation.
The 1990s

- In the 1990s, the reform process continued:
  - Private sector involved in infrastructure development through BOT concessions (1991-92);
  - Competition in telecommunications (multi-carrier system, 1994);
  - Anti-trust rules (1994);
  - Upgrading of banking regulation (1997);
  - Gradual adoption of inflation-targeting regime (1991-99);
  - Abolition of the exchange rate band (1999).
In the recent years

- Chile has continued strengthening its macroeconomic and institutional framework:
  - Structural fiscal surplus equivalent to 1% of GDP was adopted by a fiscal rule (2001);
  - All capital controls were abolished, completing the opening of the capital account (2001);
  - Capital market reform (2001);
  - FTAs continued and were signed with major trade partners: European Union (2002), EFTA (2003), United States (2003), South Korea (2003), China (2005) and P4 (2005);
  - Competition Tribunals were created (2003).
3. Performance of the Chilean economy
Economic performance

- With the reforms, Chile acquired solid macro fundamentals together with modern and robust institutions, all necessary elements for attaining high and sustainable growth rates.

- During the 1990s, Chile was one of the fastest-growing economies in the world, largely due to efficiency gains.
  - Closed its per capita income gap with developed countries by 30% in twenty years;
  - Sharp contrast with the experience of other economies in Latin America, however still modest when compared to Asian developing countries.
- Gradual decline in inflation and inflation volatility, approaching industrial-country levels.
Economic growth during the nineties (% per year)

Source: IMF.
Solow’s decomposition of economic growth: Chile

Relative per capita output
(per capita GDP over per capita GDP of G-7, PPP; 1980=1)

(*) Asian 4: Malaysia, Indonesia, Thailand and Philippines.
Source: Own calculations.
Inflation rate
(1975-2006)

Note: For developed countries, data 2006 based on forecast World Economic Outlook (September 2006).
Sources: Central Bank of Chile and IMF.
Inflation volatility
(standard deviation of rolling five-year window)

Sources: Central Bank of Chile and IMF.
Successful monetary policy

- The inflation target, maintaining inflation most of the time around 3% with a tolerance range of +/- 1 percentage point, has been reached successfully:
  - From Jan 2000-Dec 2006: Inflation averaged 2.9%;
  - As a percentage of time (months), annual inflation has fallen:

<table>
<thead>
<tr>
<th>below 2%</th>
<th>between 2% and 4%</th>
<th>over 4%</th>
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<tbody>
<tr>
<td>15.5%</td>
<td>73.8%</td>
<td>10.7%</td>
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- Among 19 inflation-targeting countries, Chile ranks first in terms of smaller deviation from target and first in global inflation-targeting success (magnitude, persistence and frequency of deviation episodes).
Inflation target and inflation rate
(monthly average, annual percent change)

Source: Central Bank of Chile.
Relative deviations to the year 2004 (%)

Note: Considers the starting period of an inflation-targeting scheme to the year 2004. The initial period of an inflation-targeting scheme varies across countries. Source: Albagli and Schmidt-Hebbel (2005).
Aggregate performance index

Note: The index considers inflation rate deviation with respect to the target in countries with inflation-targeting schemes, since the start of inflation targeting through December 2004.

Source: Albagli and Schmidt-Hebbel (2005).
Commercial and financial integration

Due to the continuing process of commercial integration, Chile experienced a notably trade performance. Trade openness is higher compared to other Latin American countries and to world average.

Chile’s financial integration has increased remarkably since the 1990s. Financial openness is considerably higher than in other emerging countries, achieving developed-market levels.
Trade openness
(% GDP, 1970-2005)

Note: Measured as the sum of exports and imports in percent of GDP.
Sources: World Bank and IMF.

Note: Measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.
Sources: Lane, Philip and Gian Maria Milesi-Ferretti (2006) and IMF.
Social indicators

- The fast expansion of this period allowed Chile to improve social indicators substantially:
  - Incidence of poverty was cut in half in fifteen years;
  - Mortality rate and life expectancy have also improved sharply.
Poverty rate
(%, population below poverty line)

Note: Present stands for 2005 in Mexico, Colombia, Brazil and Ecuador; for 2004 in Malaysia and Peru; for 2003 in Chile, Poland, Hungary, China and Philippines.
Infant mortality (per 1000 live births)

Life expectancy at birth (total years)

Main strengths

- As a result of all of the above, Chile is today better prepared than in the past (and compared to other emerging economies) to accommodate shocks.
- Chile’s main strengths include:
  - A proved macroeconomic framework;
  - Solid fiscal situation and very low public debt (a negative consolidated net public sector debt);
  - Robust financial system;
  - Strong institutions (e.g., rule of law, independent central bank).
Macroeconomic management (ranking, 2006)

Note: The number beside each bar represents the place in the ranking.
Contribution of monetary policy to macroeconomic performance (ranking, 2006)

Note: It is quantified in a scale from 1 to 9. The number over each bar represents the place in the ranking.
Fiscal balance
(% GDP, average 1995-2005)

Sources: Moody’s and Chile’s Ministry of Finance.
Public debt (1) (% GDP, 2005)

(1) General government debt. (2) As of September 2006.
Sources: Moody's and Chile’s Ministry of Finance.
Banking system strength (index, 2006)

Note: It is quantified in a scale from 1 to 13.
Source: Central Bank of Chile, based on Moody’s Financial Strength Ranking (December 2006).
Quality of institutions
(index, 2005)

Note: Average of six indexes: rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability.
Rule of law
(index, 2005)

Note: Index measures protection of individuals and property against violence or theft, independent and effective judges, and contract enforcement.
Good international evaluation

- Chile is today one of the most competitive emerging market economies;

- Country risk is among the lowest;

- Moreover, the *World Bank* report on the ease of doing business ranks Chile 28th among 175 countries in 2006. Chile is top of the list in the region.
Competitiveness
(rank ranking, 2006)

Note: The competitiveness index measures country’s ability to achieve high and sustainable per capita GDP growth. The number beside each bar represents the place in the ranking.
Country risk (basis points)

Note: As of January 19, 2007.
Source: JP Morgan Chase.
Ease of doing business
(rankings, 2006)

Note: The ranking on ease of doing business averages country indicators across ten topics: starting a business, dealing with licenses, hiring and firing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business. The number beside each bar represents the place in the ranking. Source: *World Bank* (2006).
Attractive tax system

- Chile’s tax system is attractive to investors:
  - Tax burden is low according to per capita income;
  - Corporate tax is among the lowest (17%);
  - Tax system is efficient:
    - Based on a VAT complementing the income tax that includes several exemptions to eliminate distortions to saving.
    - Integrated tax system: corporate tax is discounted from personal income taxes.
Tax burden and per capita income (2006)

GDP per capita 2005 (US dollars, PPP)

Corporate tax rate (%)

Sources: PricewaterhouseCoopers and IMF.
Corporate tax rate
(%, 2006)

Source: PricewaterhouseCoopers.
4. Conclusions
Conclusions

- The new economic model built over the last three decades is the main rationale for Chile’s outstanding economic performance of the past twenty years.

- Chile’s experience shows that there are some key elements in achieving sustainable economic growth:
  - Macroeconomic stability with autonomous central bank and solvent fiscal sector;
  - Robust and sound financial sector;
  - Strong and stable institutional setting;
  - Competitive open-market economy;
  - Comprehensive social network.
Conclusions

- The solid macro fundamentals and robust institutions, together with the good prospects for the world economy, allow us to look at the future with optimism.

- GDP growth for 2007 is projected to be in the range of 5%-6%.

- But economic development is a continuous process, and Chile still faces important challenges:
  - Education, especially regarding quality;
  - Technological innovation.
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