Chile's growth opportunities and challenges to development *

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Many thanks to the Council of the Americas —and particularly to Susan Segal— for inviting me to participate in this conference. It is a great pleasure to be here. I was asked to talk about growth and development and I will do so; however I will also touch on issues related to macroeconomic, and in particular, to monetary policy.

In our latest monetary policy report published in March, one of the central messages was a sharp reduction –about 75bp-- in our growth prospects for the Chilean economy for 2016, with a very slow recovery towards 2017. This adds to two previous years of average growth of just 2%, well below historical averages. What are the reasons behind this marked growth slowdown? Chile is a small open economy with a large copper mining sector, whose most important client is China. Consequently, Chile's economy benefited enormously from the copper price boom in the decade spanning from 2003 to 2012. Investment in the mining sector increased from around 3% of GDP in the first half of the 2000s to a peak of more than 8% of GDP throughout 2013. This force undoubtedly contributed to the country's post global financial crisis growth figures, with economic growth averaging 5.3% between 2010 and 2013. And just as there is little doubt that the commodity boom played a major part in the expansion of the economy up to 2013, one should not underestimate the importance of the commodity price bust in the last few years in slowing down growth. Actually, our further adjustment of growth prospects responds significantly to the worsening we perceive in the external scenario, although there are also idiosyncratic factors at play.

One important consequence of this negative external shock has been the sharp depreciation of the Chilean peso, which has been fueled further by a tighter monetary policy of a recovering US economy and a more expansionary monetary policy in Chile. This depreciation has a direct link with domestic prices, being the main driver of the above target inflation we've experienced since 2014. This deadly duo of low growth and high inflation is especially troublesome for central banks, which on the one hand wish to cushion the blow from negative shocks which transitorily drag activity below potential output, while at the same time being bound –and rightly so—to deliver inflation in the medium term close to the target. I should also add that these forces are today at play in most, if not all, Latin American economies. Like Chile, LATAM is heavily dependent on commodities, and its countries are also characterized by domestic inflation which responds strongly to movements in the US dollar. Indeed, Peru, Colombia, and especially Brazil have also seen depreciations of their currencies and surges in domestic inflation. With this background in perspective, one could say that the landing from the commodity bust has been particularly smooth in our country. It is also important to note than from a monetary policy standpoint we have been able to maintain a very expansionary policy stance in an environment with inflation above target, because inflation expectations have remained very well anchored to our 3% target during all this period. This a clear proof of the credibility that the Central Bank of Chile enjoys.

But today's talk will not be about the problems and tradeoffs that the Central Bank of Chile has had to deal with in the last two years. It will be about a key determinant of our policy framework, the medium term, sustainable level of economic growth. Medium term growth is not necessarily the same as the potential output growth that is relevant in determining inflationary pressures in the short term. It is the level of growth at which the economy should stabilize in the medium run once the effects of economic shocks fade away. At the Central Bank we follow closely this notion of medium term growth, as it plays the role of an anchor in our economic models. I should also mention that not only the Bank is interested in this notion. I am also sure the Finance Minister who spoke earlier in this conference, spends many hours pondering about what the level of medium term growth is for the Chilean economy, as does the panel of experts who revise every year the main parameters governing the estimation of the sustainable fiscal budget.

What do we know about the medium term level of output growth in Chile? I should begin by saying that this is not an easy measure to come up with, since it is different from the level of growth that we experience today, no doubt still influenced by the lingering effects of the negative external shocks I just mentioned. Nor it is simply the average economic growth of the last 5, 10, or 20 years, since as most economists learn early on in their introductory Macro courses –but often forget when writing columns in newspapers— there is a strong force driving down economic growth called economic convergence. We have certainly experienced this force in Chile in the recent past. The golden period of growth, as it is sometimes referred to the decade spanning 1987-1997 (with growth over 7% on average), was no doubt the effect of a huge boost coming from the correction of important distortions in the economy. But as the country grew and got closer to the frontiers of international “good practices”, attaining fast growth became harder and harder. Indeed, our internal estimation of medium term growth, say for the next 10 years, is about 3.5%, a number very much in line with the estimates of the Finance Ministry and many economic observers. Let me mention that it is also a number not different from that of economies that have reached the per capita income that Chile currently has. What is behind this number? While I encourage you to read our exact methodology described in last September’s Monetary Policy Report, I will briefly highlight what I see as the main drivers of our economy’s long term growth.

Economic growth depends on two broad forces. The first is the speed of accumulation of productive factors, namely labor and capital. The second is about how productively these factors are combined to yield output, and it’s often referred to simply as total factor productivity growth.

Let me begin with the labor input. There are many aspects that determine how much the workforce of a particular country contributes to economic growth. First, there is the issue of “how many”. This is influenced mostly by demographic trends, and as you know, this particular force will contribute relatively less in the future than it has done in the past. On the one hand, an ageing population means that the share of people in their prime working age begins to slow down. On the other hand, there is a marked trend –not only in Chile, but internationally— of fewer working hours as economic development improves. In the case of Chile, however, these forces are counteracted to some extent by an increased participation in the labor force by women, whose current participation is significantly lower than in OECD countries. Be that as it may, the demographic side to labor force participation as a whole implies that its contribution to growth will steadily decrease.

Of course, one must also take into account that the level of education of the workforce is not the same today as it was 20 years ago, and if current educational attainment trends are maintained or further increased this could be a force that adds up to growth. In our inflation report last September, we performed a projection exercise that assumes a convergence of educational attainment in Chile to current OECD levels in the next 20 to 30 years. More than convincing you about our particular estimate of the impact of better education on growth, it is worth emphasizing that on this point the result of economic and educational reforms are of paramount importance, as the contribution of the quality of the labor force responds much more to endogenous policy than to exogenous demographic trends. By the way, in our exercise we also assume that the female labor force participation will approach the current OECD average level in the next 20 to 30 years.

I will now briefly talk about the capital input. Our projections about this factor are essentially neutral in the estimation of medium term output growth –that is, we assume it grows at about the same speed as output itself. This is not rooted on any deep economic model, but rather on the simple observation that over the last 20 years or so the capital to output ratio has been roughly constant, with some oscillations but no clear trend. And while the theory of economic convergence implies some degree of *capital* *deepening* –a process during which capital grows faster than output—this just hasn't been the case recently in Chile. However, I do not mean by this that we should not worry about investment and downplay its importance for growth. On the contrary, I believe an important focus for policy in the coming years should be to provide the necessary incentives to boost investment. Here, the example of South Korea and other south east Asian economies jumps into mind, as these countries have achieved an important level of capital deepening in their growth transitions, and consequently, have continued growing despite the traditional convergence forces. In any case, as you can see, for the case of Chile this is a conservative assumption, since any capital deepening will result in higher long term growth.

Let me now focus on the second set of growth drivers, that is, how productively the "raw inputs" of aggregate production mix with each other. Understanding productivity growth is an important field in modern micro and macroeconomic research. What do we know about its determinants? Recent academic work has provided strong evidence that the reallocation of resources across firms and sectors is a key determinant of total factor productivity. To give you an example, in September's inflation report we showed that of the 1% average growth rate of productivity since the 1990s, about 80% (that is, 0.8% per year) was due to the reallocation of capital and labor from the least to the most productive sectors in the economy. Other work has found that, even within industries, the extent to which productive inputs can be reallocated across firms is a key driver in the productivity differences across countries. In this sense, it is clear that economic reforms contributing to enhance resource reallocation will foster medium run growth, and those that do not, will subtract from it. What can the Central Bank do in this respect? Whereas we do not deal with this type of microeconomic regulation directly, we do play an important role through the exchange rate policy. Indeed, in our view, the un-intervened process of nominal exchange rate depreciation –costly as it is for achieving the inflation target— has played a fundamental role in reallocating productive inputs from the non-tradable to the tradable sectors of the economy.

There are some additional elements that affect the overall productivity of firms that I would like to highlight in my remaining minutes. One is the cost of the energy utilized in the production process. In this dimension, I believe we have seen important progress in Chile in the last few years, and it is comforting to hear more and more frequently about new windmill projects along our coastline, or large scale solar panel projects in the north. One tends to forget, but not more than five years ago the "energy grid bottleneck" was often raised as one of the most important, if not the main, obstacle to economic growth. And this progress is particularly laudable given how environmental protection has evolved during the same time frame.

The last element I would like to mention briefly is infrastructure. The capacity of farmers to deliver their produce fast and unharmed, of exporting firms to ship their containers to clients abroad in a timely manner, and even the ease of workers to commute to their workplace on a daily basis is tightly linked to the overall infrastructure of the country. Obviously, the quality of a country's infrastructure affects most of the elements I described above, including the incentives to accumulate physical and human capital, as well as the growth in overall productivity. Public spending on infrastructure is clearly a budget issue which is tied to the constraints of the structural rule in Chile, and therefore while we would all like it to grow faster, there are limits to what direct public expenditures can achieve. It seems therefore that if we are aiming at achieving a faster rate of medium term, sustainable growth, this effort should be complemented by a more ambitious plan of public-private partnerships and/or concessions in order to boost infrastructure expenditure.

To sum up, I wish to highlight that those growth rates of 7% or even 5% year after year are not likely to return in a consistent fashion. While we at the Bank estimate medium term output growth at about 3.5% for the next 10 years or so, there are many levers that can be adjusted and many factors at play that can change that number. Is it that important whether it is 4.0% instead of 3.5%, or whether it is just 3%? Of course it is. The key issue here is that these are differences that add up over time, so that after even a decade, the impacts of just a mere 1 percentage point gap build up to significant differences in overall economic development, as well as on the fraction of people living below the poverty line. It is up to economists and policymakers, but also up to politicians, to understand which policies and reforms are conducing to growth and which are not, and we must acknowledge that whether we stir the economy in one direction of another will have the most significant consequences on welfare in the medium and long term.

I want to finish with a positive note. From a macroeconomic point of view, Chile is a very solid, stable and balanced economy. Its financial sector is stable, well-regulated and well supervised. It has a fiscal rule which provides for a responsible fiscal policy. The full commitment to it has meant that currently Chile's net public debt is nil. Not many countries can exhibit this achievement. It has an independent central bank with an inflation targeting scheme that, as mentioned earlier, enjoys great credibility. It has also a flexible exchange rate policy and it is precisely the exchange rate the variable that efficiently acts as shock absorber. The current account deficit is small. It has also solid institutions well recognized internationally. All this make me think that Chile is in good position to begin a new era of higher rates of economic growth.

Thank you very much.