

Outlook for the Chilean Economy

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I. External shocks in a growing economy

The Chilean economy has experienced high economic growth and overall macroeconomic stability during the past fourteen years. Average growth in the period 1985-1998 was above 7% a year, among the fastest growing economies in the world. This remarkable performance rests on sound structural and macroeconomic fundamentals: a high investment ratio, a high rate of productivity increase, declining inflation and a healthy financial position. Although the economy has been facing complex conditions, associated with the global crisis, it is important to observe that the same strategy of openness and stability, which created the environment for solid growth in the past, is providing the means to ride the waves of the current crisis.

Chile has a very open trade regime, with high specialization in its allocation of resources. This feature has allowed rapid growth of exports all over the world, but it has also made the economy more vulnerable to external shocks. In order to reconcile these two contradictory influences, the current economic policy puts emphasis on maintaining strong fundamentals, which include a solid international liquidity position, stable financial system, strict fiscal management, and well-established microeconomic foundations, based on market-oriented incentives.

International economic events since late 1997 seriously affected the Chilean economy. The change in external conditions may be summarized in three facts. First, Chile's export to Asia amounted to 35% of total exports before the crisis and this region reduced imports by almost 25% during 1998. Second, exports of copper represented almost 37% of total exports and the price of copper fell by 27% in 1998. Third, net capital inflows decreased from 9.4% of GDP in 1997 to 4.3% of GDP in 1998. These factors together meant that in 1998 the Chilean economy was one of the worst hit in the world, excluding, of course, the Asian economies.

The severe deterioration of external conditions followed a period of strong acceleration of internal demand, which was accompanied by a widening current-account deficit. The main cause of this expansion was the private sector's favorable expectations regarding the prospects of the Chilean economy and the availability of internal and external financing. The expansion of internal demand was more evident during the fourth quarter of 1997 and was mainly channeled towards the external markets, pushing import growth to 20%. However, demand pressure also affected domestic markets, generating a hefty growth of GDP and a tightening in the labor market.

These factors triggered a wave of currency substitution in the balance sheet of private-sector companies and institutional investors, which stressed the currency market in the first three quarters of 1998. This sector had accumulated a strong domestic-currency position in the eve of the Asian crisis and tried to restore a more balanced arrangement during 1998.

II. Macroeconomic policy

In this scenario domestic spending had to be curbed, which in turn would allow for an orderly adjustment of relative prices and prevent a reversal of the downward trend of inflation. Thus, the policy objectives in early 1998 were to rapidly reduce the current-account imbalance; while maintaining the basic equilibrium of the economy, thereby favoring medium-term growth. The economic policy coherent with these objectives was based on a tight monetary and fiscal position.

In the monetary area, the Central Bank promptly raised the interest rate in order to restrain private spending. During 1998 monetary and credit aggregates showed a severe deceleration in their growth pace, leading the break in the trend of domestic spending. Also, short-term liquidity was tightly controlled in those episodes of brusque changes in financial expectations, in order to defend the peso in an increasingly uncertain environment.

By the end of the third quarter of 1998, the marked decline of the external imbalance led to currency and financial markets stabilization. The Central Bank proceeded at that time with a gradual but significant reduction in interest rates, from 14% in September 1998 to 7% today. Also, over this recent period the 90-day rate decreased faster than the overnight rate, reflecting market expectations for a speedy normalization of interest rate. Likewise, longer-term interest rates have descended to levels similar to the 1992-1997 average. Furthermore, the premium on nominal and dollar-denominated instruments has also significantly decreased. The current stance for monetary policy looks for a gradual recovery of economic growth in 1999 and 2000.

Regarding exchange-rate policy, the actions of the Central Bank have been guided by two criteria. First, recognize and acknowledge the most permanent market trends of the exchange rate. Second, avoid the risk of short-term nominal overreaction. In some circumstances these two criteria may appear contradictory, as each specific step of the exchange-rate policy might incorporate a higher weight of one of the two criteria, and thus be misinterpreted in the light of the other. But in the long run it is easy to realize that the real exchange rate fluctuates with changes in the internal and external medium-term conditions of the economy. In specific episodes of sudden shifts in market expectations and confidence, an excessive nominal depreciation of the peso was halted by strong but temporary forex intervention, restriction of short-term liquidity and narrowing of the exchange-rate band. Only looking at the sequence of several measures of the Central Bank, one gets the balance of the two principles that have guided the

exchange-rate policy in Chile for several years.

As financial markets stabilized in the last quarter of 1998, the Central Bank widened the exchange-rate band, permitting the market to pursue a peso value coherent with the changing internal and external conditions. The interest differential between domestic and international rates has recently descended fast and the spread over treasury of Chilean corporations in the bond markets has also declined. The Brazilian episode had no significant impact on the developments of financial markets. After some initial effects, there was no significant shift in confidence or expectations.

As a result of this policy and the changes in market conditions, the exchange rate has reacted through a nominal depreciation of 15.5% between the first two months of 1999 and the average of 1997. In the same period, the real exchange rate shows a depreciation of around 5%. In view of these figures, it can be stated that exchange-rate policy has kept the exchange rate within moderate margins and, at the same time, has been compatible with a greater degree of flexibility, coherent with the trends of fundamentals and other macroeconomic policies.

Fiscal policy has also accomplished an important effort to support the adjustment policy by reducing expenditure, although most of the fiscal contraction in 1998 took place in the last quarter, contributing to a further shrinking of economic activity. Considering a normal pattern of the budget execution in 1999, public spending can be expected to grow around 2.8% in real terms, similar to GDP growth, while government accounts will continue to show a small surplus, despite the contraction in revenues.

III. Economic developments and prospects

The bulk of the transition from a high growth path, in a rapid growing global economy, to a moderate growth track, compatible with the new external conditions has already been made. The main variables of the external sector, economic activity and inflation are evolving along this desired path. This behavior supports the macroeconomic program applied since early 1998 and generates the stability condition that favors medium-term prospects.

1. Trade balance and current account

The trade balance shows a sharp increase in the deficit from mid 1997 to August 1998 and a strong recovery since then. The factors that explain this evolution are: (i) the deterioration of the terms of trade; (ii) the positive response of exports volume during the crisis; and (iii) the restraint of imports due to the contraction of domestic spending.

The global crisis reduced the price of basic products, among which the copper price has an important influence on the Chilean trade balance. Copper fell from US\$1.03 a pound in 1997 to US\$0.75 in 1998. For 1999 Central Bank projections consider a price of US\$0.68 a pound. On the other hand, the external crisis also originated reductions in the dollar prices of imports, especially oil. The deterioration of the terms of trade reached 11.5% in 1998, which is equivalent to two percent of GDP and had a negative impact on the trade deficit of US\$ 1.4 billion. For 1999, the average of terms of trade is expected to fall another 5.4% with respect to the average for 1998, which is equivalent to a non significant recovery or deterioration from current levels.

The volume of exports grew 6.2% in 1998 as copper exports increased by 6.4% while non-copper exports grew by 6.1%. These figures show that the effect of the global crisis was moderate, given the exposure of Chile to the Asian market and the experience of previous periods of deceleration of international activity. This reasonable behavior was thanks to the substantial reorientation of exports to more stable markets. Prospects for exports consider a recovery of copper shipments due to the start-up of new projects, some increase in forestry, fishmeal and methanol, while the outlook for other exports remains more uncertain, since they depend on the evolution of world markets. The Central Bank estimates growth of 8.5% for total exports in 1999.

Concerning the trend of imports there is a striking shift in the third quarter of 1998. Until then, imports were growing fast, in line with domestic spending and economic activity. In the second half of 1998 this trend reverted to a negative growth of imports. For the year as a whole there was a decrease of nominal imports by 4%, which is the result of a volume increase by 2% and a 6% fall in price. The Central Bank projection for 1999 considers a slight decrease in import volume and a price increase of 2%.

The risks coming from external imbalances have declined significantly, since the trade deficit has shown a downward trend since September 1998, reaching US\$2.5 billion in December. This falling trend is expected to continue to reach a deficit close to US\$2.0 billion by the end of 1999. Also, the Central Bank expects the current-account deficit to be further reduced from US\$4.5 billion, or 6.2% of GDP, in 1998 to some US\$3.7 billion, or less than 5% of GDP, in 1999. These figures show that the bulk of the adjustment to new external conditions has already taken place and currently Chile is recovering a path of moderate growth, sustainable in the medium term.

The current situation in Brazil does not significantly modify these projections. Brazil accounts for 5% of total Chilean exports, and a significant slowdown of markets in Latin America had already been contemplated.

2. Capital-account and balance of payments

Regarding the capital account two facts were especially relevant in 1998: (i) a sensible increase in the demand for international assets on the part of domestic agents and (ii) the slowdown in capital inflows.

The increase in private-sector demand for international assets was especially powerful in the first three quarters of 1998. Private pension funds increased investment abroad by US\$1.4 billion during 1998. By year-end, foreign assets accounted for 5.7% of the fund. Non-institutional investors, including banks, companies and individuals, also made similar portfolio adjustments. Foreign direct and portfolio investment by domestic residents amounted to US\$4.2 billion in 1998. It is expected that in 1999, capital outflow for this concept will be lower than that of last year, due to the fact that most of the portfolio changes have already been made.

External financial conditions also reduced capital inflows compared to the strong flows observed in previous years, mainly portfolio inflows as ADRs and new bond issues. This may be interpreted as a normal movement, since Chile has continued attracting investment and medium-term financial resources. Direct foreign investment amounted to US\$6.5 billion in 1998, only 5% below the record high level of 1997. For 1999 it is expected that medium- and long-term capital inflows will continue as an important source of external financing. Other components of the capital account, as portfolio investment, are more uncertain. However, they do not have a significant role in the financing of the balance of payments.

Given this scenario, external resources will comfortably finance the current-account deficit and due amortizations. But, even in a more restrictive external scenario, Chile enjoys a solid international reserve position that stands at US\$15 billion, which is equivalent to about 11 months of imports and about 48% of broad money.

3. Economic activity

The evolution of economic activity reflects the intended transition from high growth, before the Asian crisis, to moderate growth, while uncertainty of the world economy prevails. This movement is a natural consequence of the new external scenario of the Chilean economy. Thus, GDP growth continuously declined from 9.6% in the fourth quarter of 1997 to around -3.0% in the last quarter of 1998. The slowdown in growth is especially visible in the sectors that are more affected by the cyclical position of the economy, as manufacturing, construction and commerce. However, additional factors also had an impact on economic activity in the second half of 1998, including reduction in mining growth, smaller fishing catch due to El Niño and negative consequences of drought on agriculture and hydro-electricity generation.

Domestic demand has fallen at an even more pronounced rate than GDP, with growth falling from 11% in the first half of 1998 to below -5% in the second half. Current policy considers that domestic demand will still have a contractionary effect in the first half of this year and will return to positive growth only in the second half of 1999. Monetary aggregates are starting to show a turning point in their downward trend. For the year as a whole a slight decrease in domestic demand is expected.

The estimated GDP growth of around 3% in 1999 is based on the expected improvement of external demand. On one hand, export volumes are expected to grow by 8.5% in 1999, led by mining expansion and some increase in forestry, fishmeal and methanol. Other exports are expected to register only moderate growth, according to external conditions. On the other hand, import levels are likely to remain constant during 1999, as the result of low growth of economic activity, decrease of inventories and exchange rate depreciation.

The recent easing of monetary policy is consistent with a recovery of domestic demand only in the second half of 1999, continuing at a moderate pace through 2000. Although private estimations of GDP growth in 1999 vary, disagreements are more related to the pace rather than the direction or sustainability of the recovery.

4. Inflation

During the past eight years, inflation has gradually fallen, consistent with targets set by the Central Bank. For 1998 the inflation rate was 4.7%, while the target was +/- 4.5%. For 1999 the inflation target is +/- 4.3% and the 12-month inflation rate in February reached less than 4.0%. In recent months indicators of underlying inflation have gradually approached the observed rate.

There are several factors behind the recent evolution of inflation. The reduction of imported inflation limited the effect of the peso depreciation on internal prices and the contraction of internal demand reduced the margins on tradables and eased the pressure on non-tradable prices and salaries. It is expected that the reduction in internal demand will have a further influence in curbing inflation toward the 1999 target.

Although during 1998 the earnings growth did not decline, the accumulation of excess capacity and the reduction of margins compensated their effect on inflation. For 1999, the increase in public-sector salaries is aligned with the inflation target and gives a signal to expect a decline in the rate of increase of salaries, consistent with the increase in productivity and inflation.

5. Financial sector

The current global crisis has once more demonstrated that a strong and efficient financial sector, with a market-oriented structure of incentives, is essential to sustain rapid growth and prevent contagion from external turmoil. The recent evolution of Chilean financial institutions confirms that this sector has a solid position, despite the effects of the slowdown in economic activity.

Aggregate lending followed the trend of GDP. From a real expansion of 13.4% in 1997, before the Asian crisis, lending growth was down to 4.5% on annual basis last December, although up-to-date monthly figures show that aggregate lending is starting to

recover higher growth rates. There is also an important change in the structure of lending, with consumer credit falling drastically, due to stricter provision rules and a more cautious behavior of both debtors and banks. Commercial credit, instead, showed a more moderate descent.

Due to the decline in economic activity, non-performing loans as a percentage of total loans increased, within reasonable levels, from 0.97% in 1997 to 1.44% in December 1998. Nevertheless, the provisions for absorbing potential losses still exceed non-performing loans, although the ratio of provisions to non-performing loans fell from 1.6 in December 1997 to 1.25 in December 1998.

Regarding other solvency indicators of financial institutions, banking after tax profit rate was 11.5% in 1998, a moderate decrease from the 13.7% reached in 1997. This reduction in profitability is mainly associated with a sound increase in loan-to-loss provisions, which in turn reflects the higher credit risk in an economy that moves from a high to a moderate growth path. In fact, provisions and write-offs relative to income generating assets increased from 0.99% in 1997 to 1.36% in 1998.

On the other hand, the risk-adjusted capital-asset ratio shows an increase from 11.5% in December 1997 to 12.5% in December 1998. This indicator is well above international minimum standards and shows that banks have improved their capital position to absorb potential losses.

It is important to note that these safe and good financial indicators reflect not only the management skills of bankers, but also the sound and strict banking regulation and the quality of supervision in Chile. This regulatory scheme, which is based on prudential norms and market-oriented structure of incentives, has provided the environment for a healthy growth of the financial system in the past ten years.

The current external crisis has once more confirmed that both macroeconomic equilibrium and financial-sector stability are basic pillars for resuming stable and sustainable growth. The Chilean economy has a sound and well-capitalized financial sector, which enables it to contribute with confidence to the gradual recovery of GDP in 1999 and 2000.

IV. Conclusions

The Chilean economy has been facing difficult times. The Asian crisis challenged the capacity of the country to accommodate to an international environment of slow growth, turbulence and uncertainty. Though the economy had sound fundamentals and cautious macroeconomic policies, it became impossible to maintain a high growth path, while the external conditions do not improve. Chilean economic authorities promptly responded to the new challenge through a clear commitment to a moderate growth process, gradual but consistent reduction of inflation and keeping the average current-account deficit within a range of 4% to 5% of GDP. Current macroeconomic policies are fully consistent with these purposes.

A transitory growth pace below economic potential is unavoidable in these new external conditions. However, at the same time, it is the requisite to attain a sustainable growth through the medium term.

Recent data shows that the Chilean economy is well advanced along this path. Chilean financial institutions are solid, the fiscal budget maintains a surplus, external accounts are within sound levels, positive rating of country risk has been maintained, inflation is under control and growth prospects are positive. Thus, economic conditions and basic macroeconomic policies are already in place to produce a gradual recovery of the Chilean economy.

Chile: Macroeconomic Indicators, 1997-1999

	1997	1998 (Preliminary)	1999 (Estimated)
GDP (% change)	7.1	3.4	3.0
Inflation (%)	6.0	4.7	± 4.3
Export volume (% change)	10.8	6.2	8.5
(a) Copper (% change)	19.3	6.4	10.0
(b) Non-copper (% change)	5.2	6.1	7.5
GFKF (% of GDP)	33.0	32.4	31.0
Current-account deficit (% of GDP)	5.2	6.2	4.9
Current-account deficit (US\$ billion)	4.0	4.5	3.7
Trade deficit (US\$ billion)	1.3	2.5	2.0
Copper price (US\$ per pound)	1.03	0.75	0.68
Terms of trade (% change)	3.9	-11.5	-5.4