BANCO CENTRAL DE CHILE

Chile's Integration into the World Economy: Achievements & Challenges

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Outline

1. Effects of trade liberalization: Theory, skepticism, and international evidence.
2. Chile’s integration experience.
3. Chile’s fundamentals.
4. Estimated effects of Chile’s free trade agreements (FTAs).
5. Future challenges for Chile in Asia and beyond.

1. Effects of Trade Liberalization: Theory, Skepticism, and International Evidence

Theory

- Efficient resource allocation.
  - ✓Commercial integration allows to concentrate production in sectors with comparative advantages, leading to efficiency gains from improved resource allocation.

- Economies of scale.
  - ✓Access to world markets leads to efficiency gains derived from larger production volume.

Theory

- Intermediate goods.
  - ✓Wider access to imports of intermediate goods improves quality of final products at lower cost, enhancing overall competitiveness.

- Technological transfer and absorption.
  - ✓Trade increases interaction with the outside world, facilitating technology transfers and the absorption of technologies and production processes that are at the international frontier.

Theory

- Consumer gains
  - ✓Opening to trade results in reduced prices, improved quality and wider variety of goods available to consumers.

- Competition
  - ✓Opening to trade increases competition in tradable sectors, further promoting technological improvements and lower prices.

Theory

- Business cycle correlation
  - ✓ Trade integration raises output correlation with trading partners, in particular with inter-industry trade, making countries less vulnerable to idiosyncratic (domestic) shocks.

Skepticism

- If free-trade is so good, why does it meet so much opposition, even at government levels?
- Anti-liberalization arguments versus facts:
  - ✓ 1. “*Trade liberalization inhibits development of infant industries at early stages of development*”.
    - US auto industry: Barriers merely delayed productivity gains. Efficiency was raised only when confronted with tougher competition.
    - In developing countries: Every industry is infant and barriers to growing up are usually elsewhere.

Skepticism

- ✓ 2. "*Trade liberalization destroys jobs, reduces real wages, and causes poverty in unprotected sectors*"
  - Employment is eventually reallocated to export-oriented, highly productive jobs;
  - Far more jobs are lost (and gained) to technical progress. Should technological progress be banned as well?
  - Each of the 2,300 jobs saved in the American sugar industry through import barriers in the 1990s cost consumers around $800,000 per year!
  - The effects on the poor stem mainly from higher prices of protected sectors, usually an important component in their consumption basket (agriculture).

Skepticism

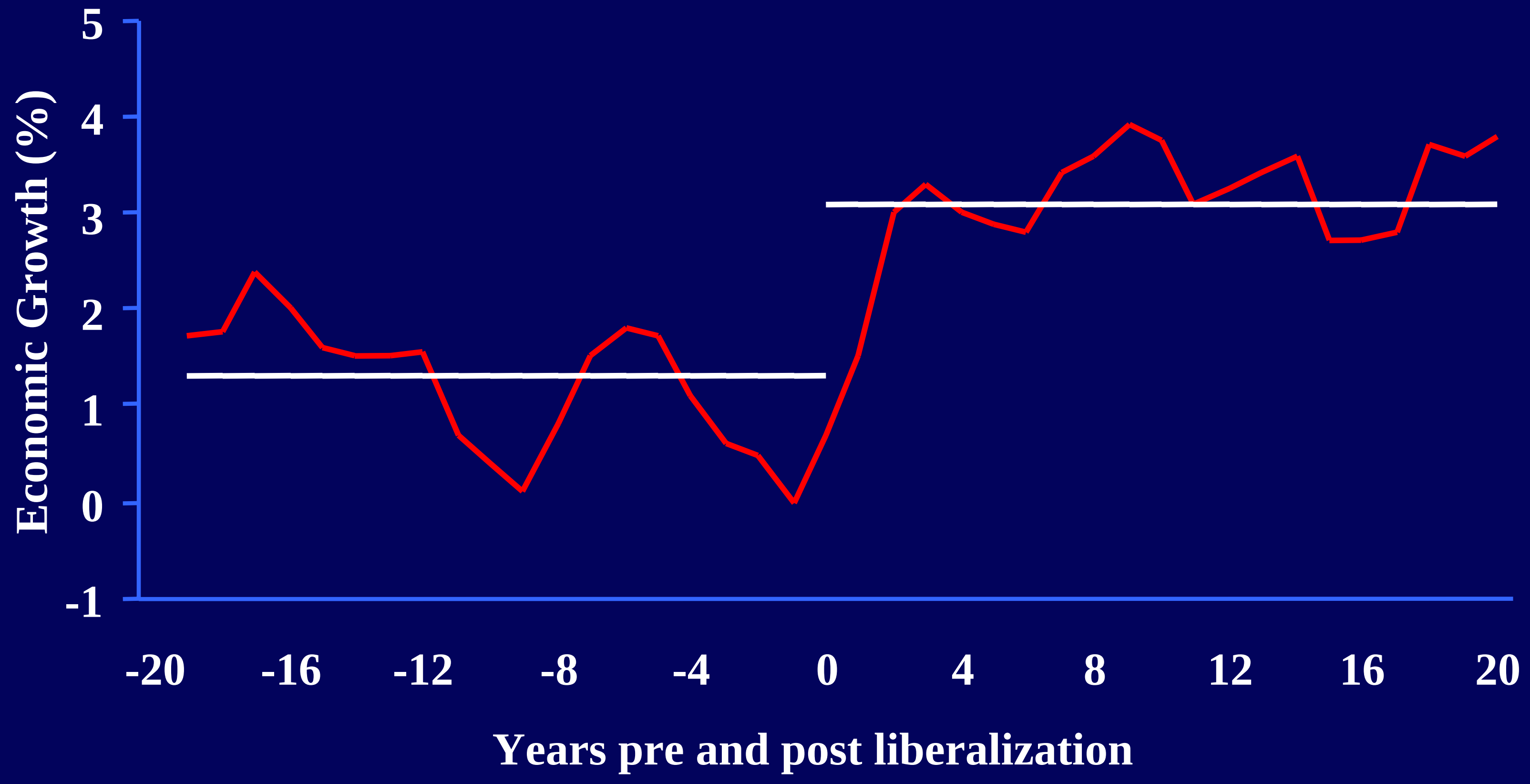
- Why then do protectionist groups often succeed in inhibiting trade liberalization?
  - ✓ They represent organized groups that spend abundant resources on persuasion and lobbying activities;
  - ✓ The most benefited group, consumers, are unorganized and/or uninformed about their benefits from trade;
  - ✓ The anti-globalization movement may have very good intentions for the world's poor, but they are often misled by subgroups motivated by self-interest.

International Evidence

- Many empirical studies find large positive effects of trade volume on:
  - ✓GDP per capita growth rates;
  - ✓Investment rates.
- Higher growth helps to reduce poverty and strengthen institutions.
- Some studies find positive growth effects of free trade agreements, which depend on:
  - ✓Economic structure (South-South, North-North or South-North);
  - ✓Size of trading partners.

Trade Liberalization and Growth

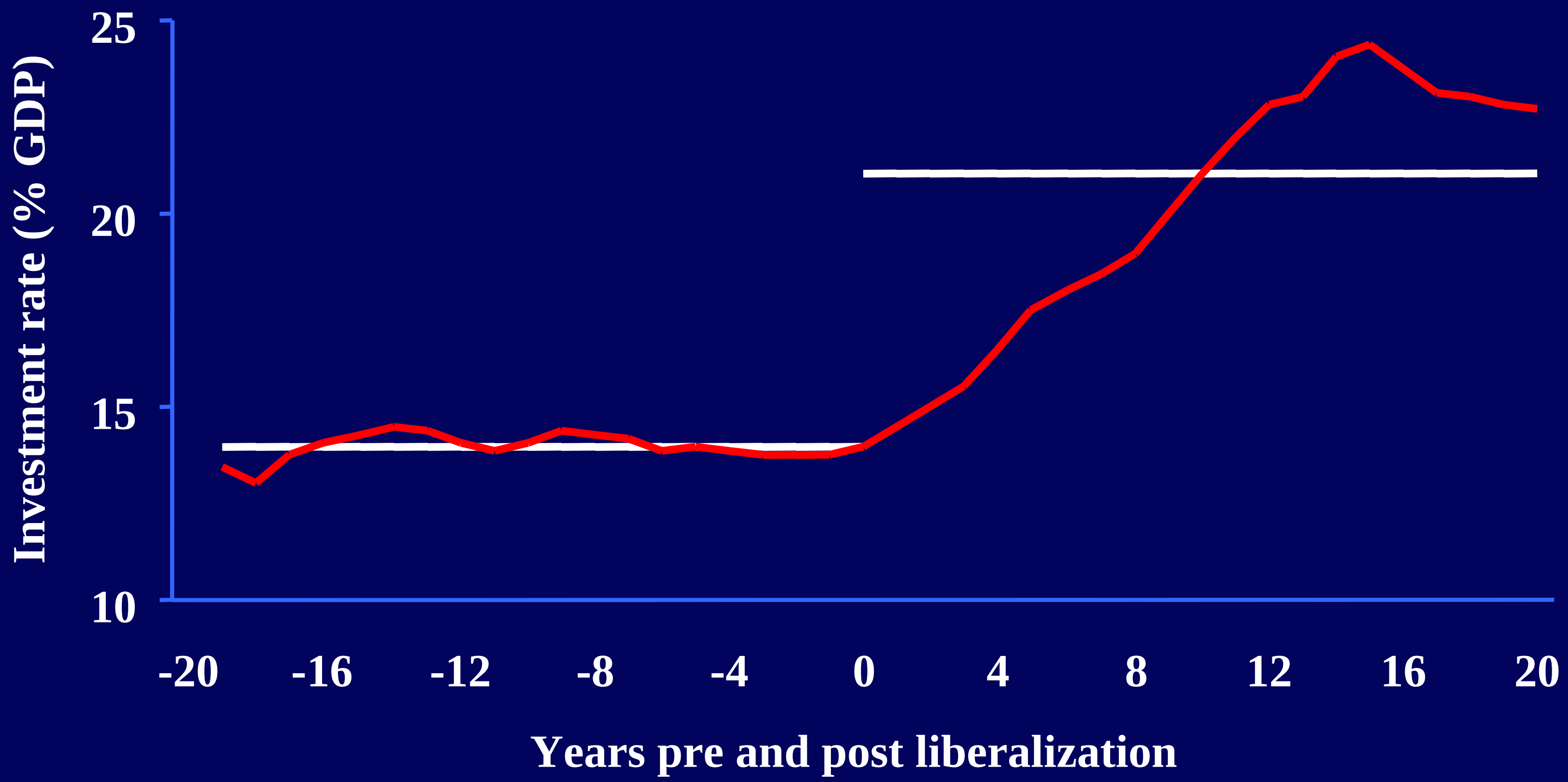
(133 countries)



Source: Wacziarg and Horn Welch (2003)

Trade Liberalization and Investment

(133 countries)



Source: Wacziarg and Horn Welch (2003)

FTAs & Growth

- Berthelon (2004) finds that if country A signs an FTA with country B of size equal to 1% of the world GDP, it raises country A's growth rate by 0.03% - 0.1%.

- He finds that a North-North agreement has unambiguous positive effects, but the effects of other types of agreements depend on partner size (and many other factors).

2. Chile's Integration Experience

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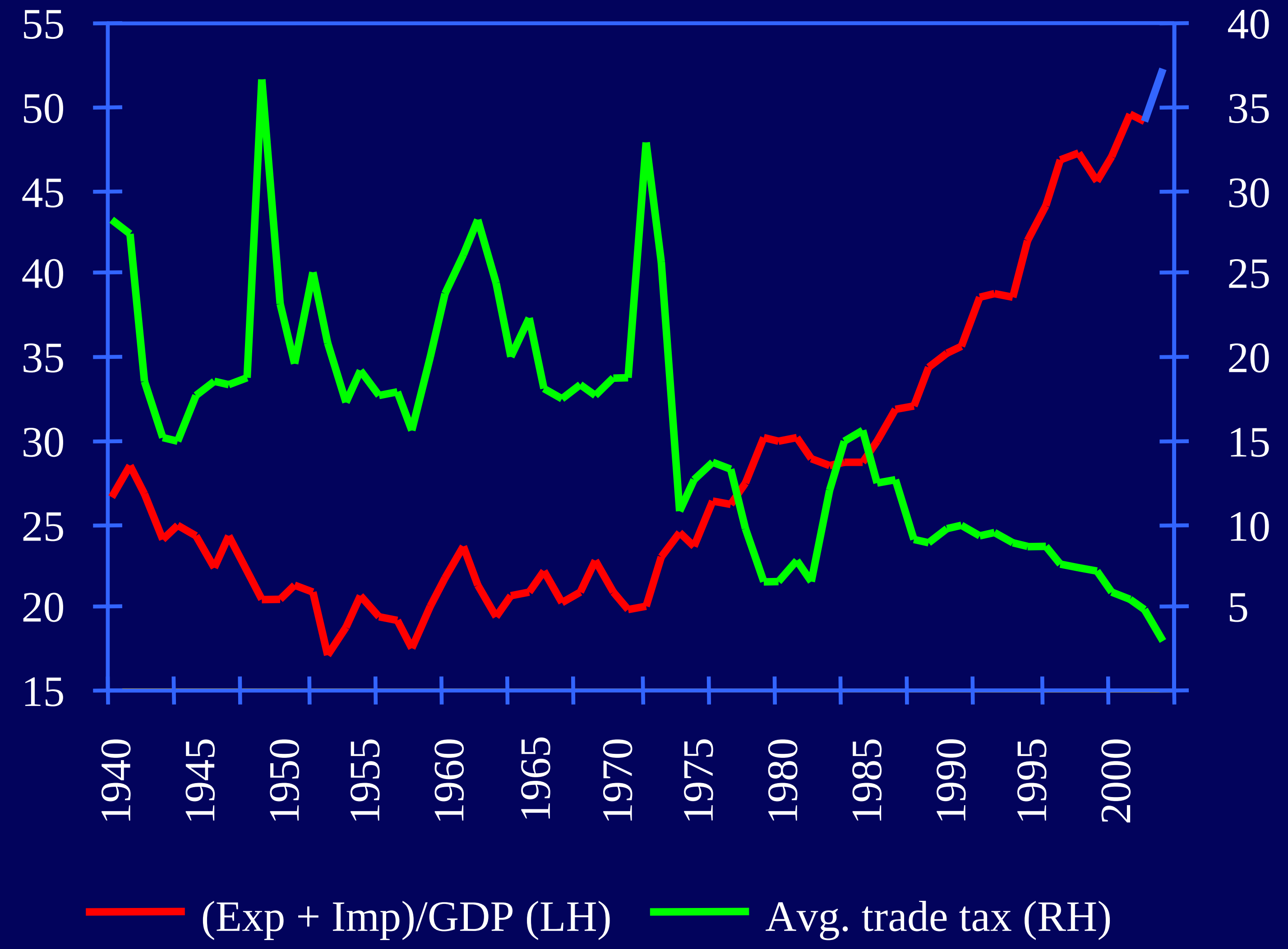
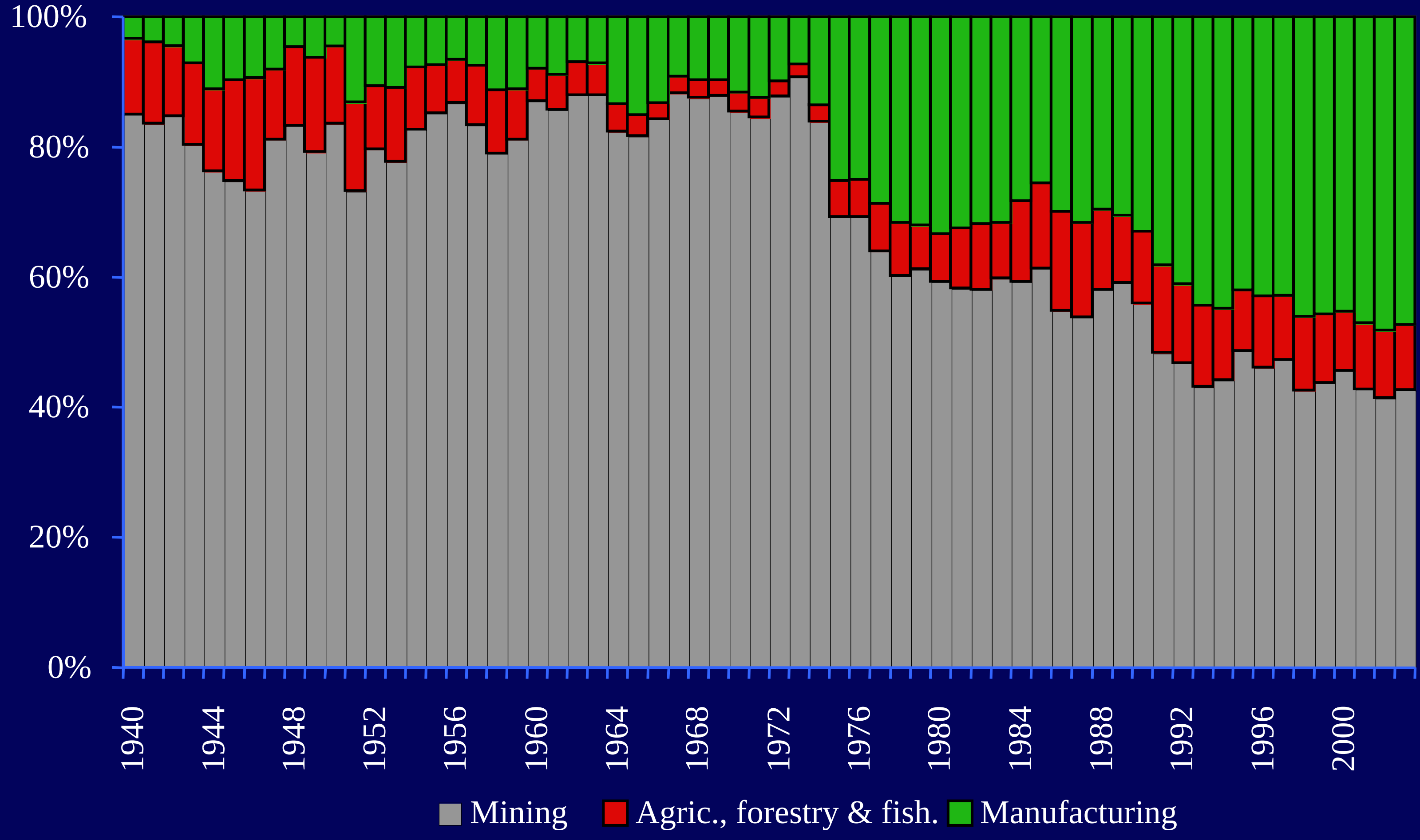
- Chile started its opening up process in the mid 1970s with a gradual dismantling of an extremely restrictive trade regime.
- The opening up has continued until today.
  - ✓ In the 1990s two large unilateral tariff cuts were introduced (1991 and 1998).
  - ✓ Several PTAs were signed to improve export access.
- Trade liberalization has been part of a much broader reform effort.

Average Trade Taxes and Trade Volume

(%)



Export Composition by Sector



Liberalization & Productivity

- Some estimated effects of the opening up process:
  - ✓ Import-competing and export-oriented manufacturing plants have raised their productivity levels significantly as a result of trade liberalization.
  - ✓ In the non-tradable sector, productivity growth has been more modest (Pavcnik, 2002).

Trade Integration Agreements

- *Present agreements:*
  - ✓Canada
  - ✓Mexico
  - ✓European Union
  - ✓USA
  - ✓Korea
  - ✓MERCOSUR
  - ✓Several other Latin American countries: Peru, Ecuador, Costa Rica, etc.
- *On the agenda:*
  - ✓Singapore
  - ✓New Zealand
  - ✓India
  - ✓China
  - ✓EFTA (advanced stage)

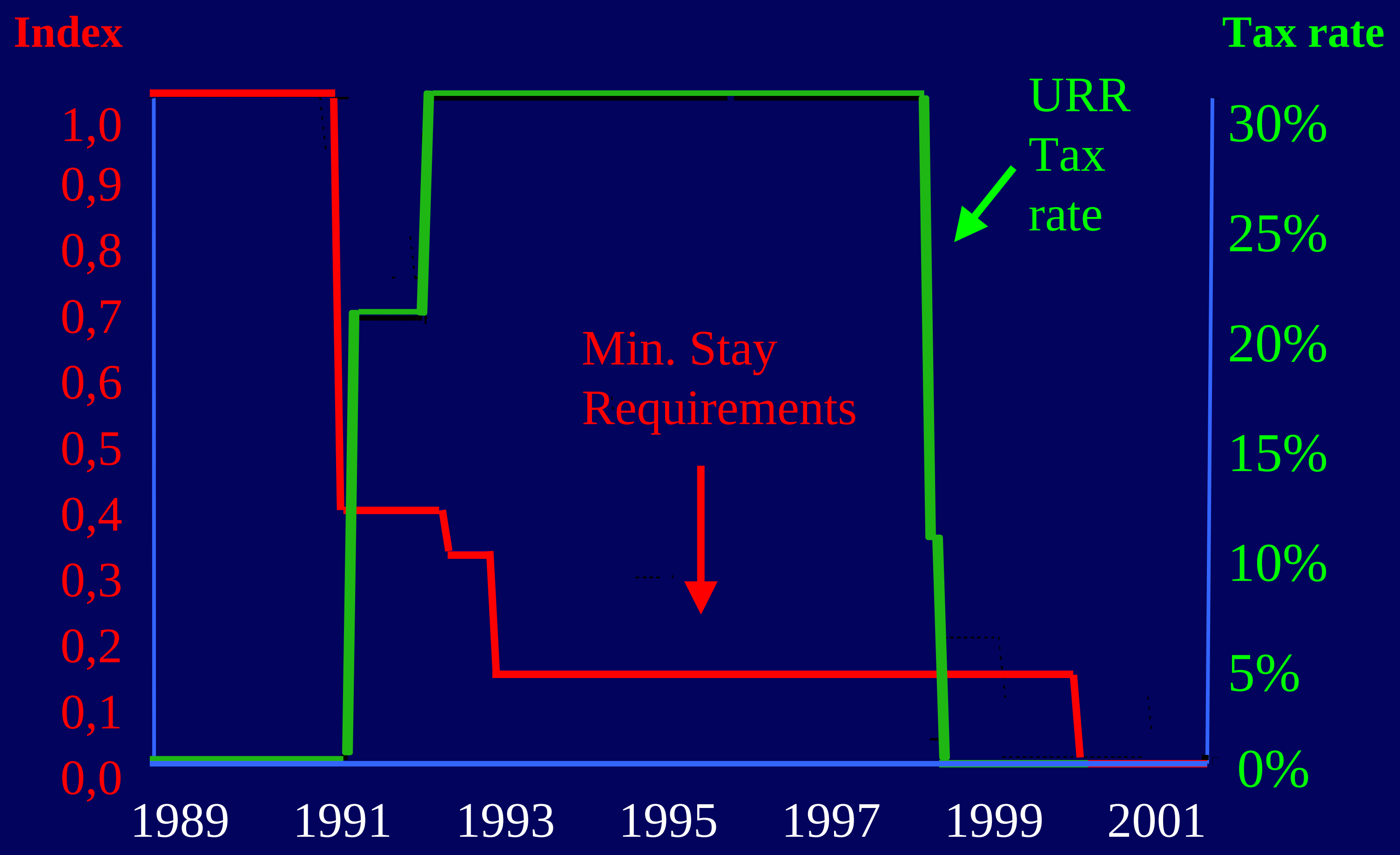
Financial Integration

- On the financial side the integration has been more gradual:
  - ✓ Chile had in place capital-account restrictions through most of the 1990s, including the well-known Unremunerated Reserve Requirement (URR) or “encaje”.
  - ✓ The rationale for the 1991-98 URR was twofold:
    - Maintain monetary policy independence without giving up the exchange-rate band (more room to maneuver);
    - Discourage volatile (speculative) capital inflows.

Financial Integration

- Once inflation had converged to the final target level and the banking system had been strengthened, the Central Bank removed all remaining capital-account restrictions in 2001.

Capital Controls



Source: Gallego, Hernández and Schmidt-Hebbel (1999)

3. Chile’s Fundamentals

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- To get the full benefits of the opening-up process, especially with regards to financial integration, it is crucial to have in place the right policies and institutions.

- But putting in place the right policies and institutions is a complex task that comprises:
  - ✓ Macroeconomic reforms;
  - ✓ Microeconomic reforms;
  - ✓ Institutional build up to support (and reap the full payoff of) these reforms.

3. Chile's Fundamentals

- What is needed on the institutional side:
  - ✓Adequate enforcement of contracts;
  - ✓A clear and competition-promoting regulatory framework;
  - ✓Adequate supervision and regulation of banks;
  - ✓Institutions that facilitate achieving and maintaining macro stability (budget process, central bank independence).
- On micro policies, the most important are those aimed at enhancing flexibility and competition.

3. Chile's Fundamentals

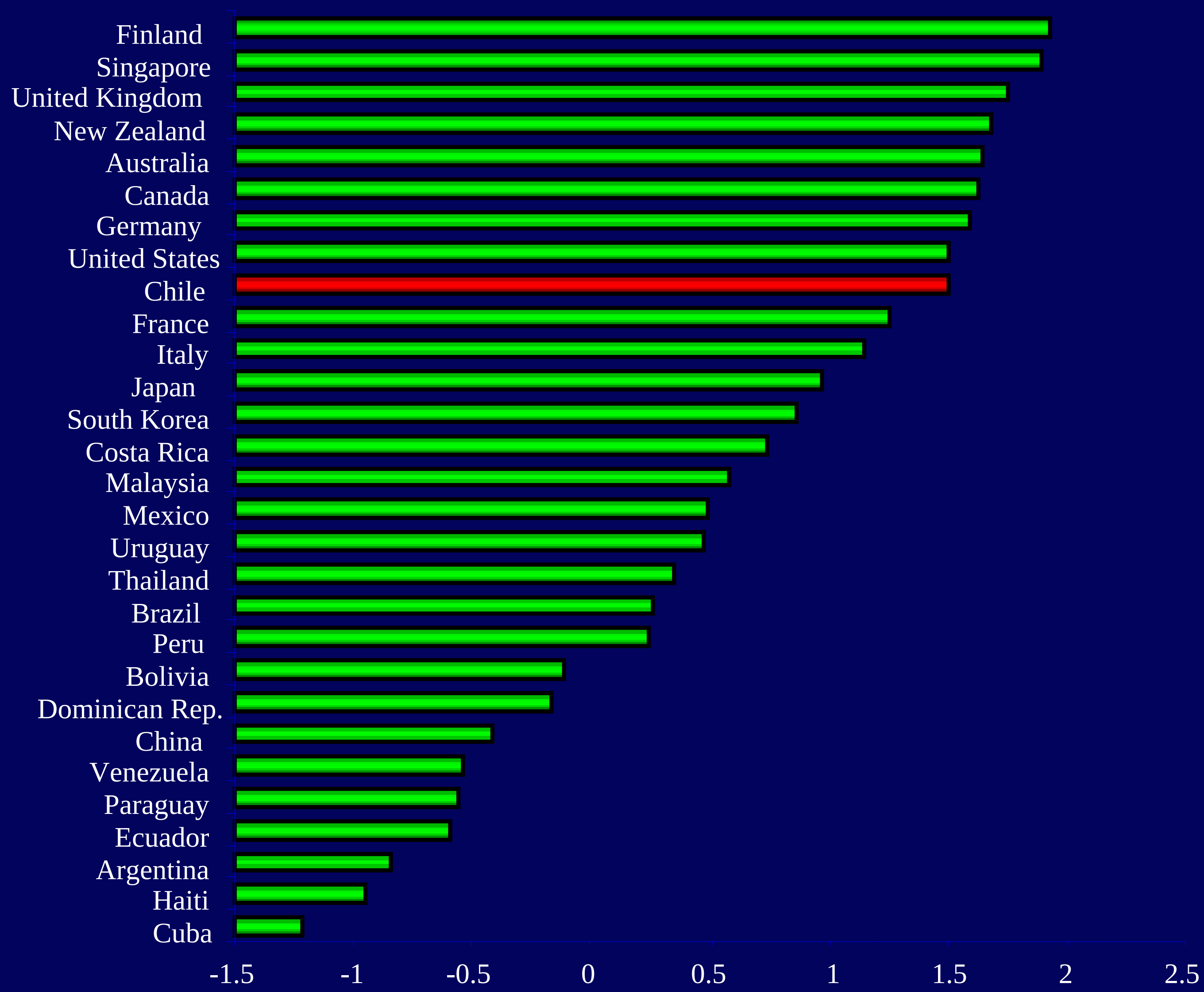
- On macro policies what is needed is to create the conditions to achieve low and stable inflation:
  - ✓ a sustainable fiscal position,
  - ✓ a consistent exchange rate-monetary policy framework.
- In the past 30 years Chile has advanced on all fronts, although not at equal pace and not without setbacks (the 1982-83 crisis was a hard way to learn about policy mistakes).

3. Chile's Fundamentals

- Progress attained on the micro and institutional fronts has placed Chile as the best ranked among emerging market economies in several areas:
  - ✓Quality of regulation
  - ✓Economic freedom
  - ✓Property rights protection
  - ✓Rule of Law
  - ✓Control of Corruption

Regulatory Quality

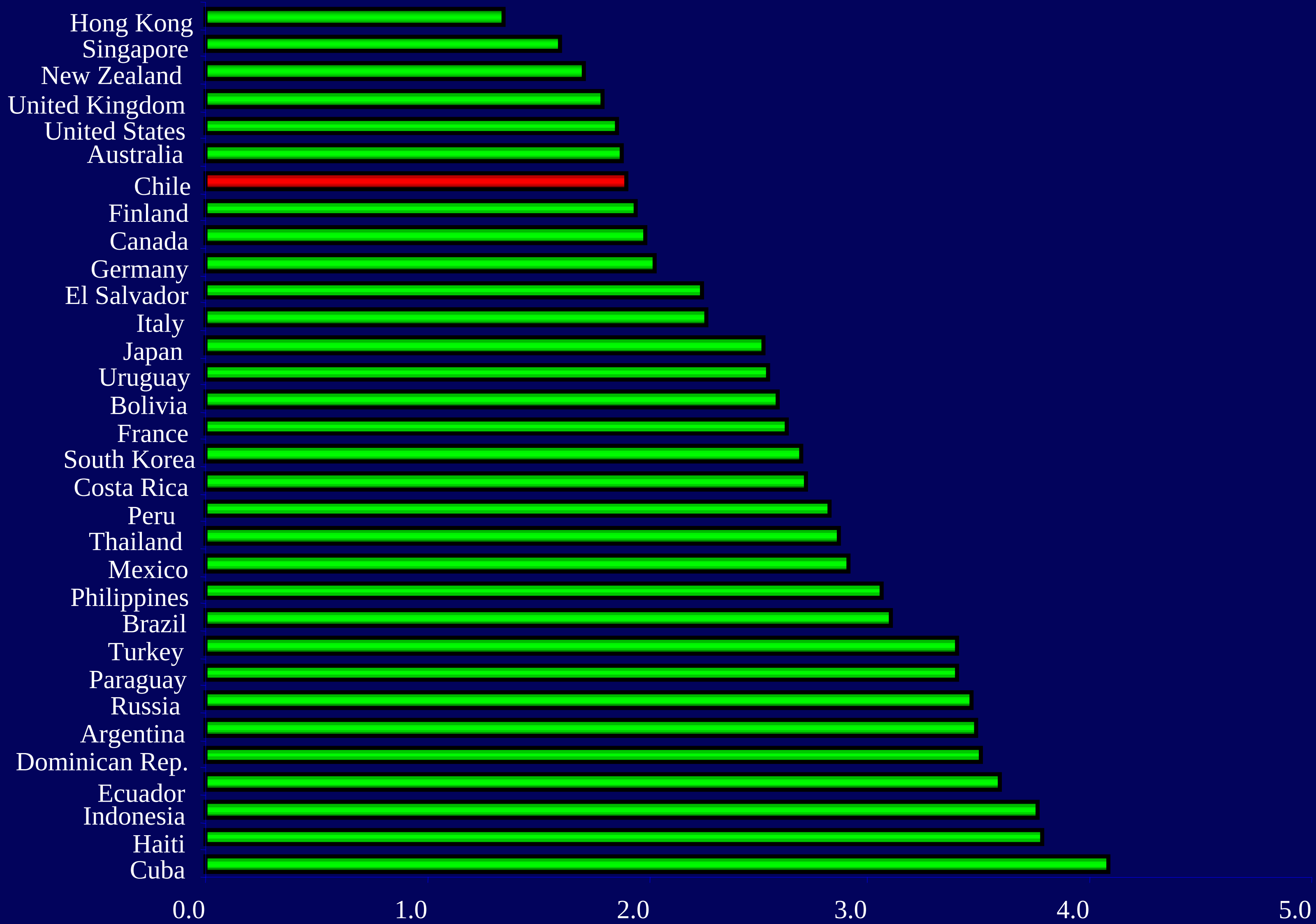
(2002)



Source: Kaufmann et al (2003)

Economic Freedom

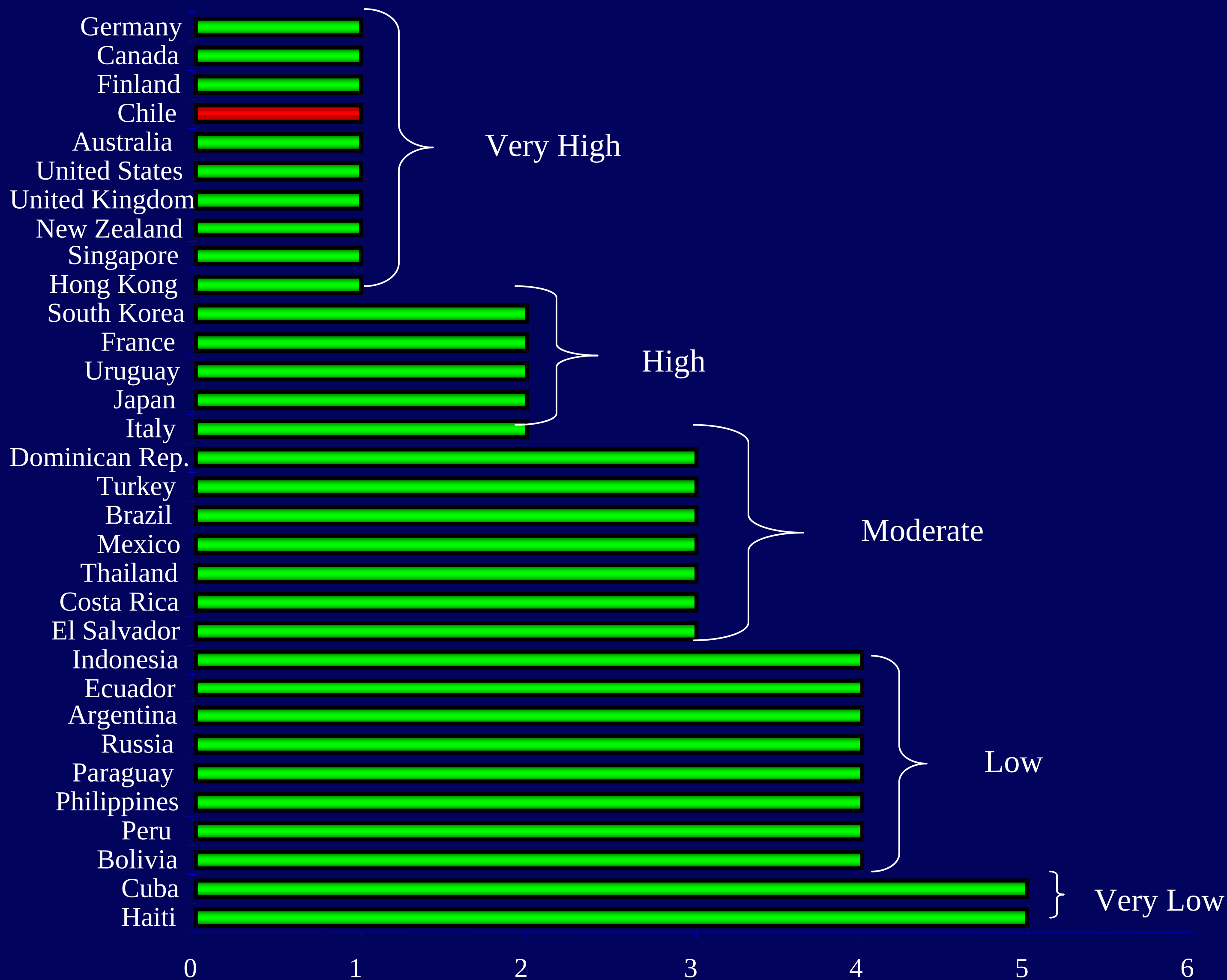
(2004)



Source: Heritage (2004)

Property Rigths

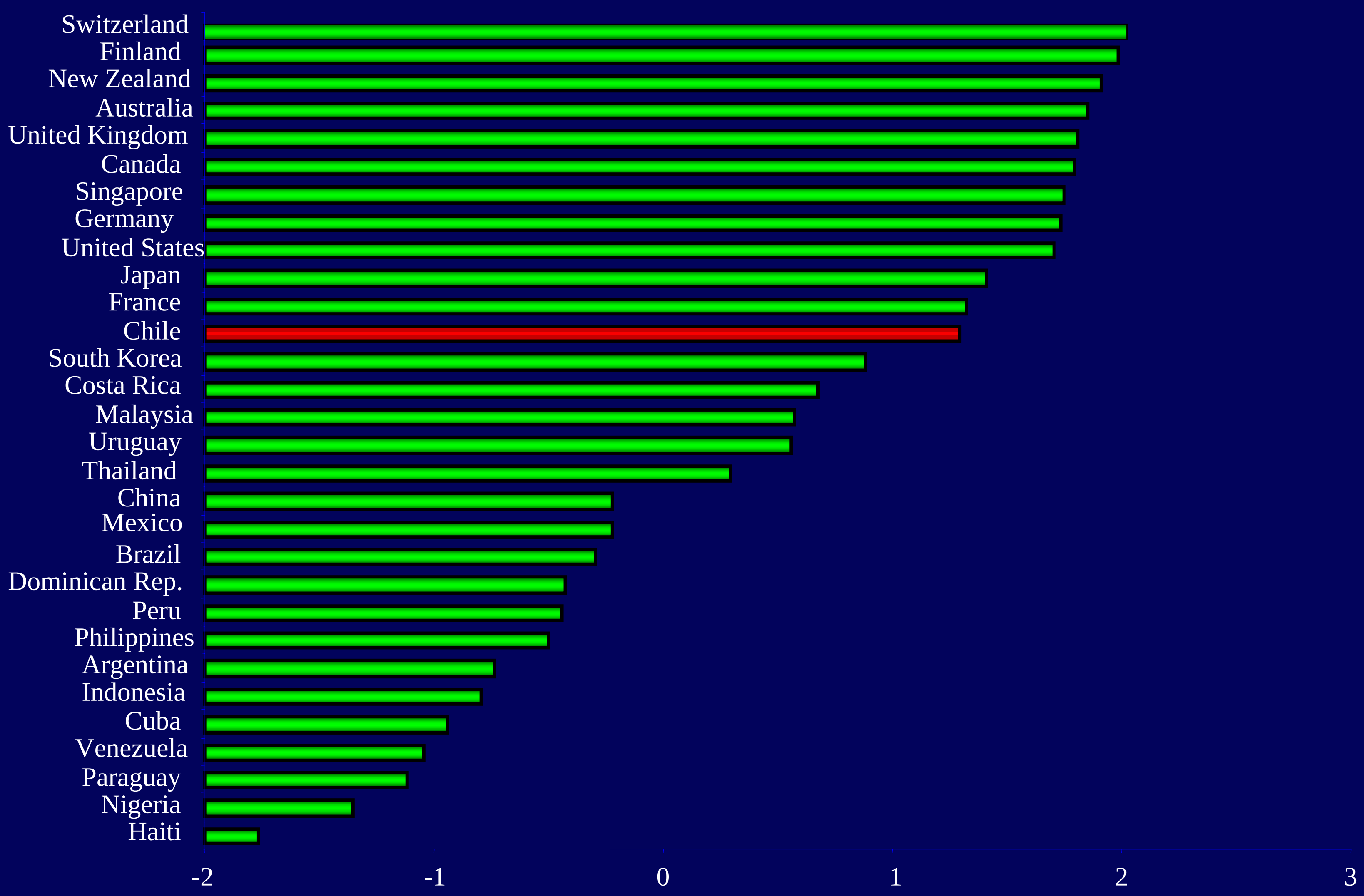
(2004)



Source: Heritage (2004)

Rule of Law

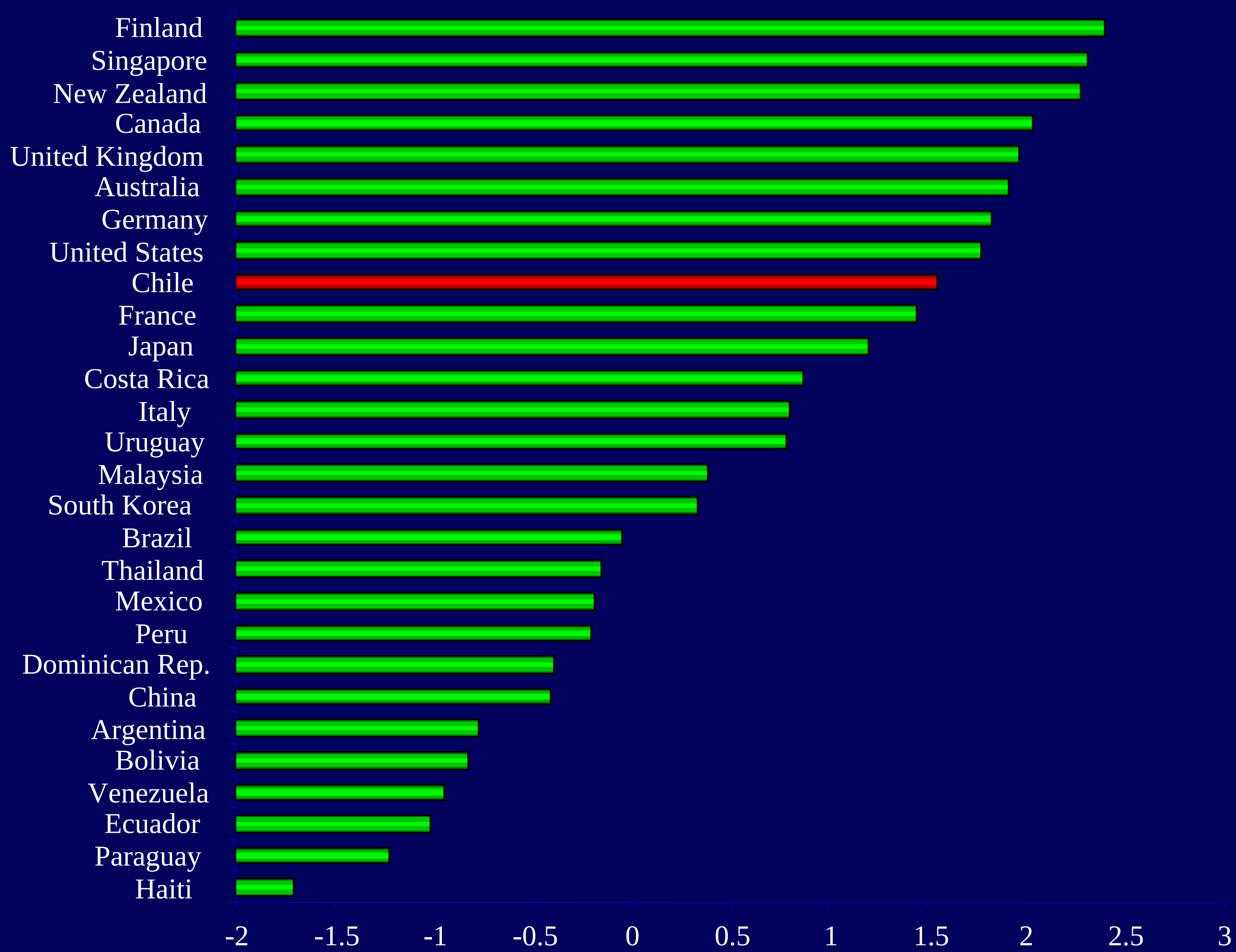
(2002)



Source: Kaufmann et al (2003)

Control of Corruption

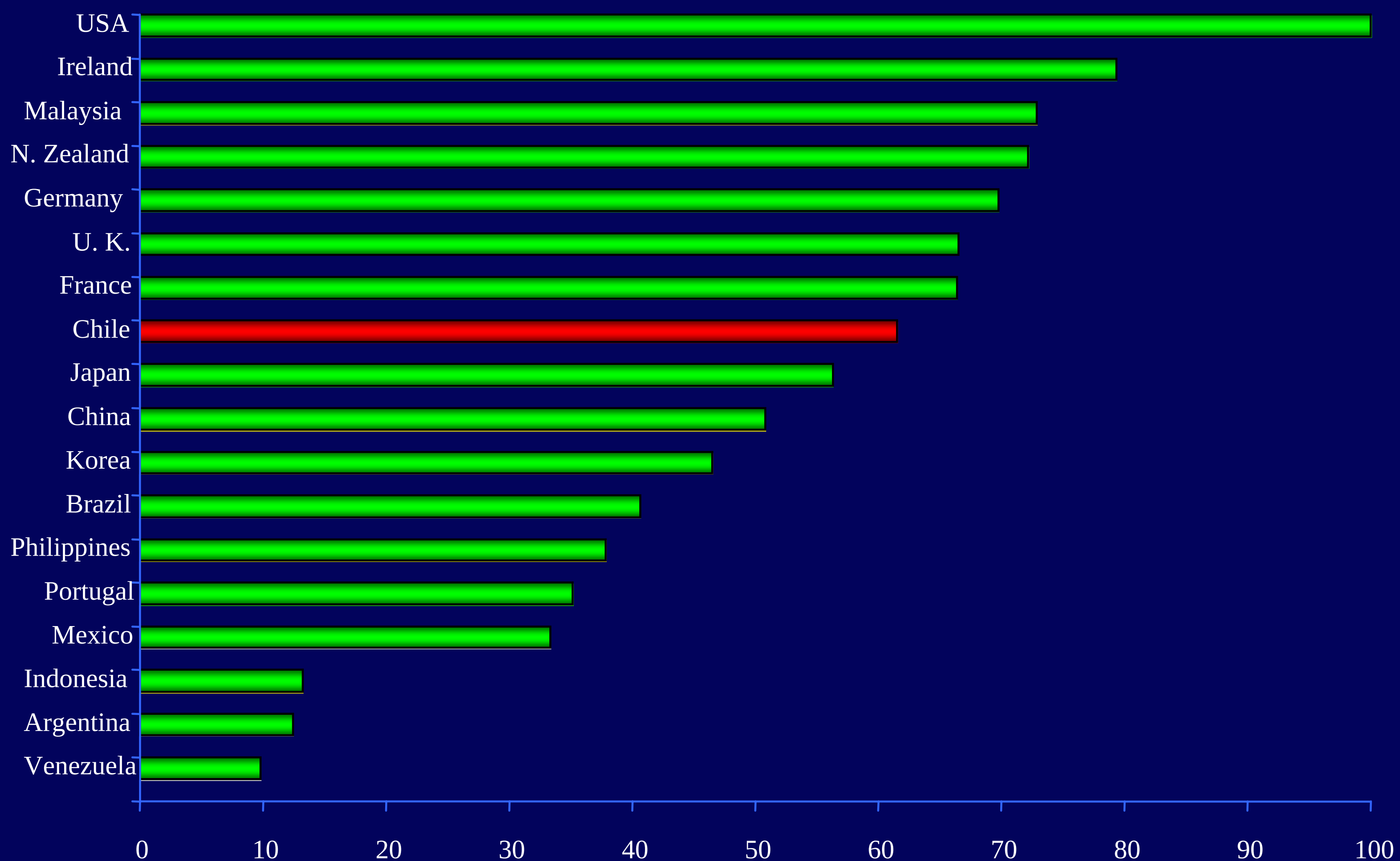
(2002)



Source: Kaufmann et al (2003)

Competitiveness Ranking

2003



Source: IMD, May 2003.

3. Chile’s Fundamentals

- On the macro side, Chile implemented a deep program of macro stabilization and structural reforms that laid the foundations for price stability and high growth.

3. Chile's Fundamentals

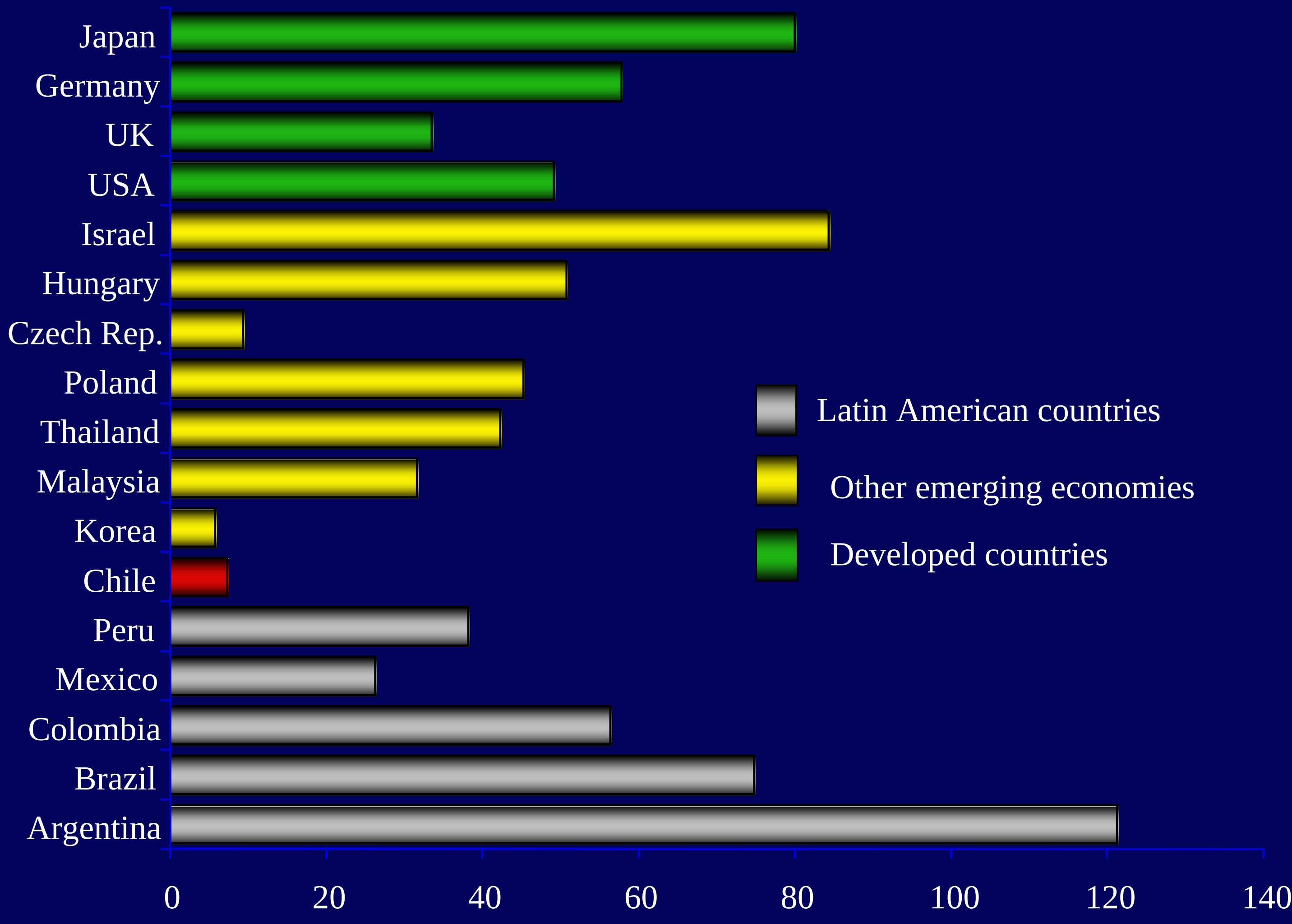
- Critical components of the strong institutions and sound policies in the macroeconomic realm are:
  - ✓Bank regulation and supervision (1986 and beyond).
  - ✓Central Bank independence (1989).
  - ✓Inflation targeting (1991).
  - ✓Flexible exchange-rate system (1999).
  - ✓1%-of-GDP structural fiscal surplus rule (2001).
  - ✓Full liberalization of capital account (2001).

3. Chile's Fundamentals

- Thanks to its policies and institutions, today Chile has strong macro fundamentals:
  - ✓Low public debt and fiscal balance;
  - ✓Low external debt;
  - ✓A credible monetary/exchange rate policy that delivers low and stable inflation and facilitates adjustment to shocks;
  - ✓A strong banking system.
- All of these have allowed the country to have a very low risk premium.

Net Public Debt 2003 (1)

(% GDP)

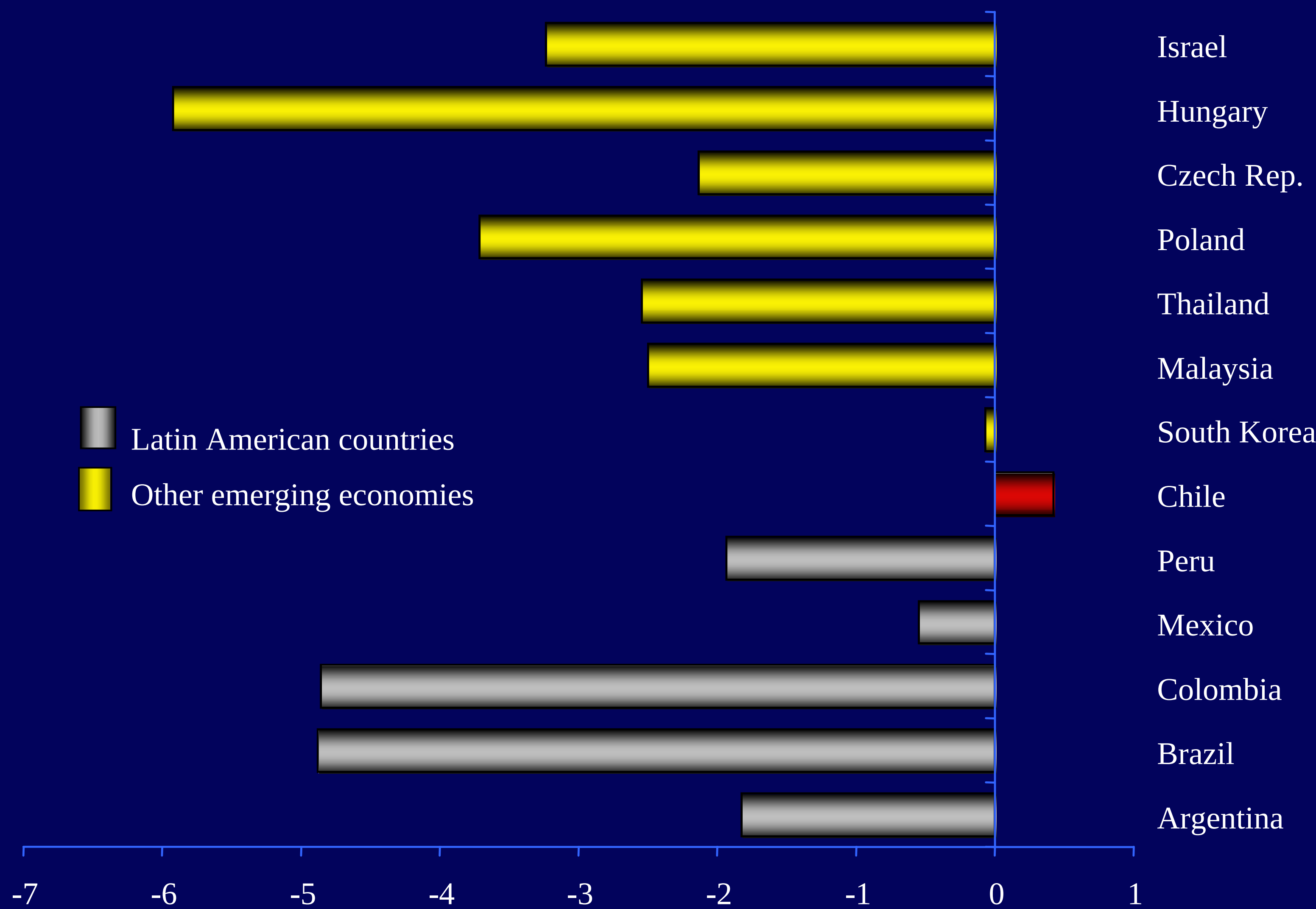


(1) The case of Chile considers Consolidated Public Sector. For the rest of countries, only the Central Government debt.

Source: Deutsche Bank, IMF Sept 2003, and Ministry of Finance.

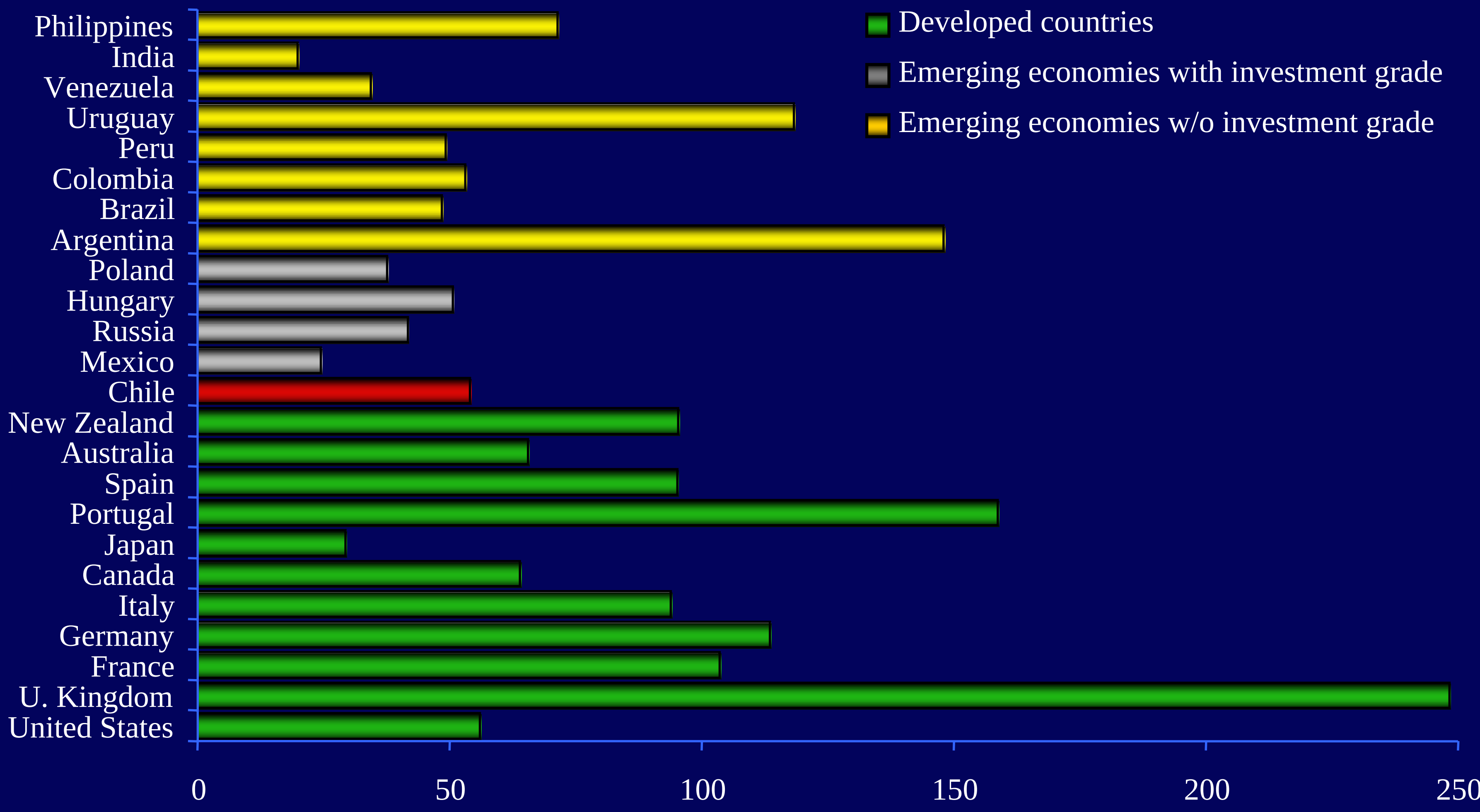
Fiscal Balance: Average 1995-2003

(% GDP)



Source: Moody's Sept 2003, Ministry of Finance.

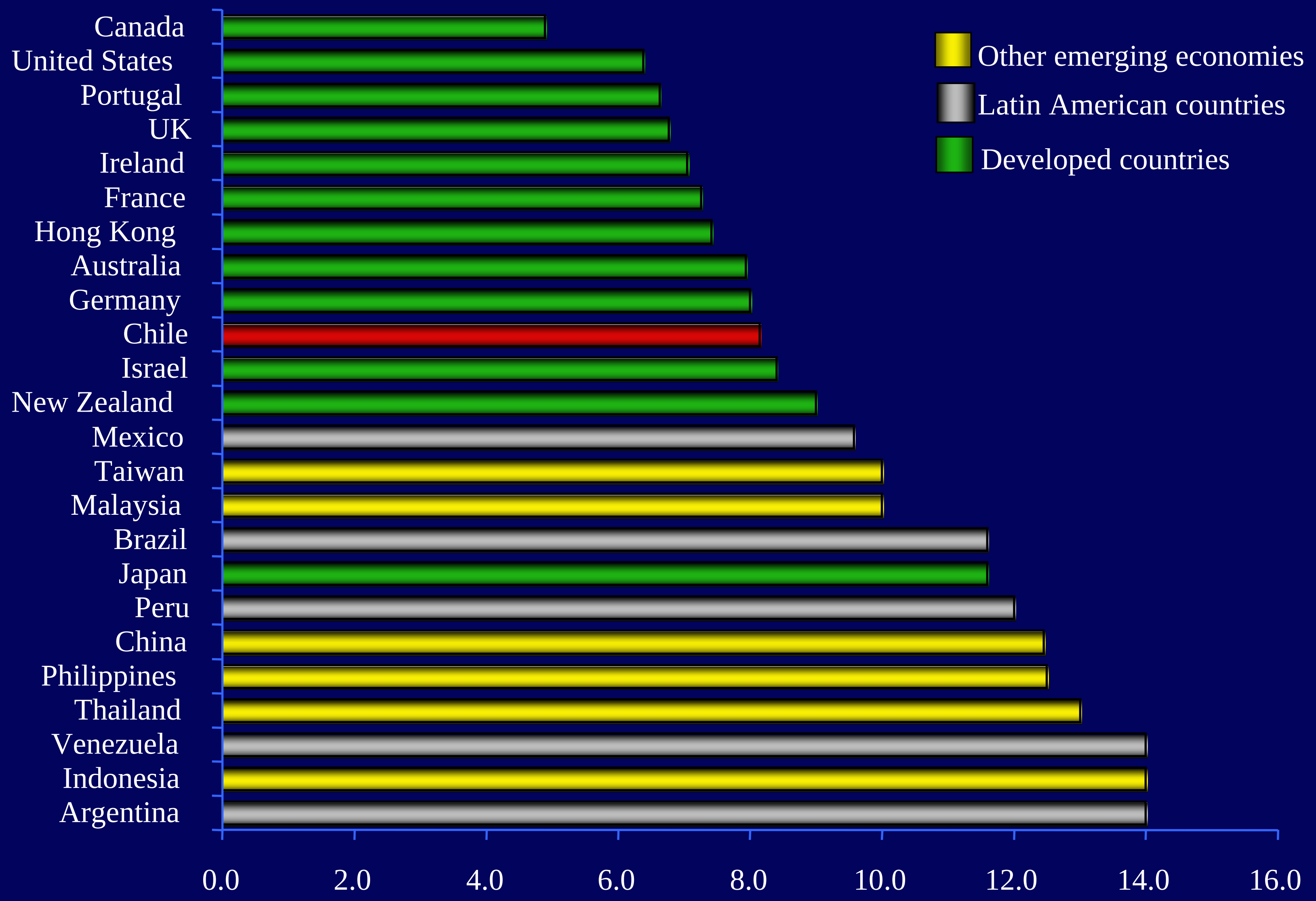
External Debt / GDP



Source: IMF.

* December 2002. External debt = Debt securities liabilities + Other investment liabilities from IIP

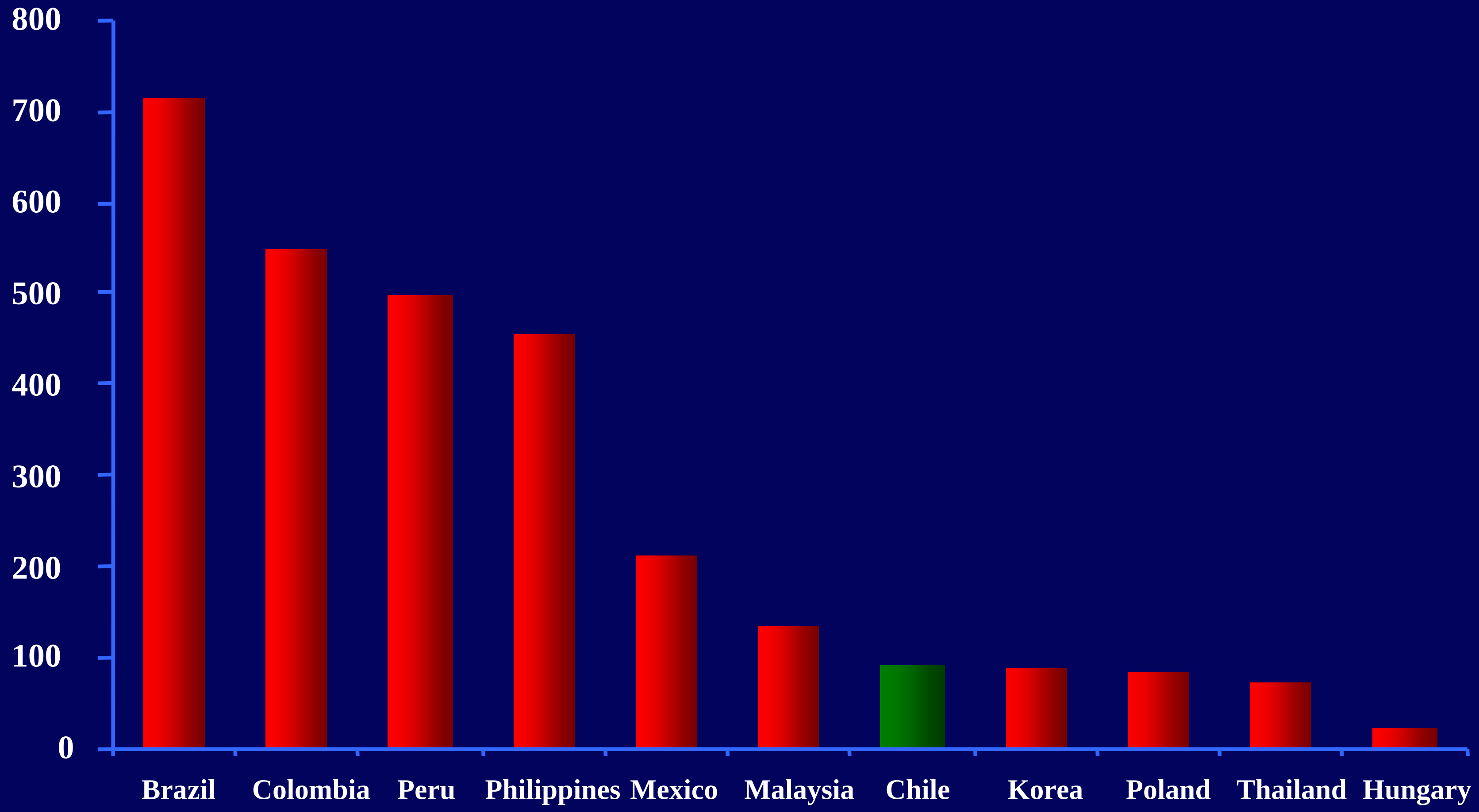
Ranking of Banking System Strength



Source: Moody’s Feb. 2004.

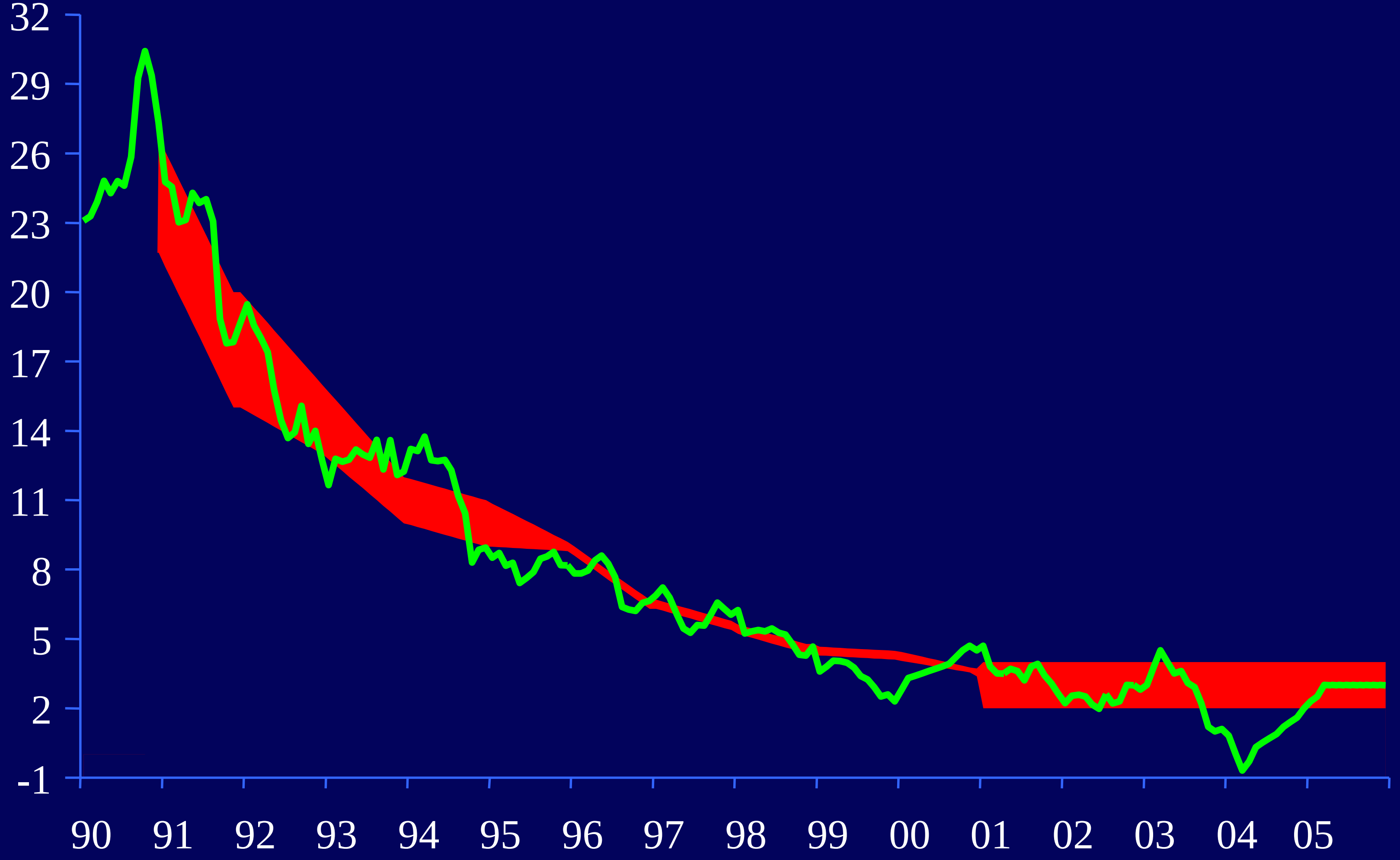
Country Risk Premium

May 26, 2004 (Pb.)



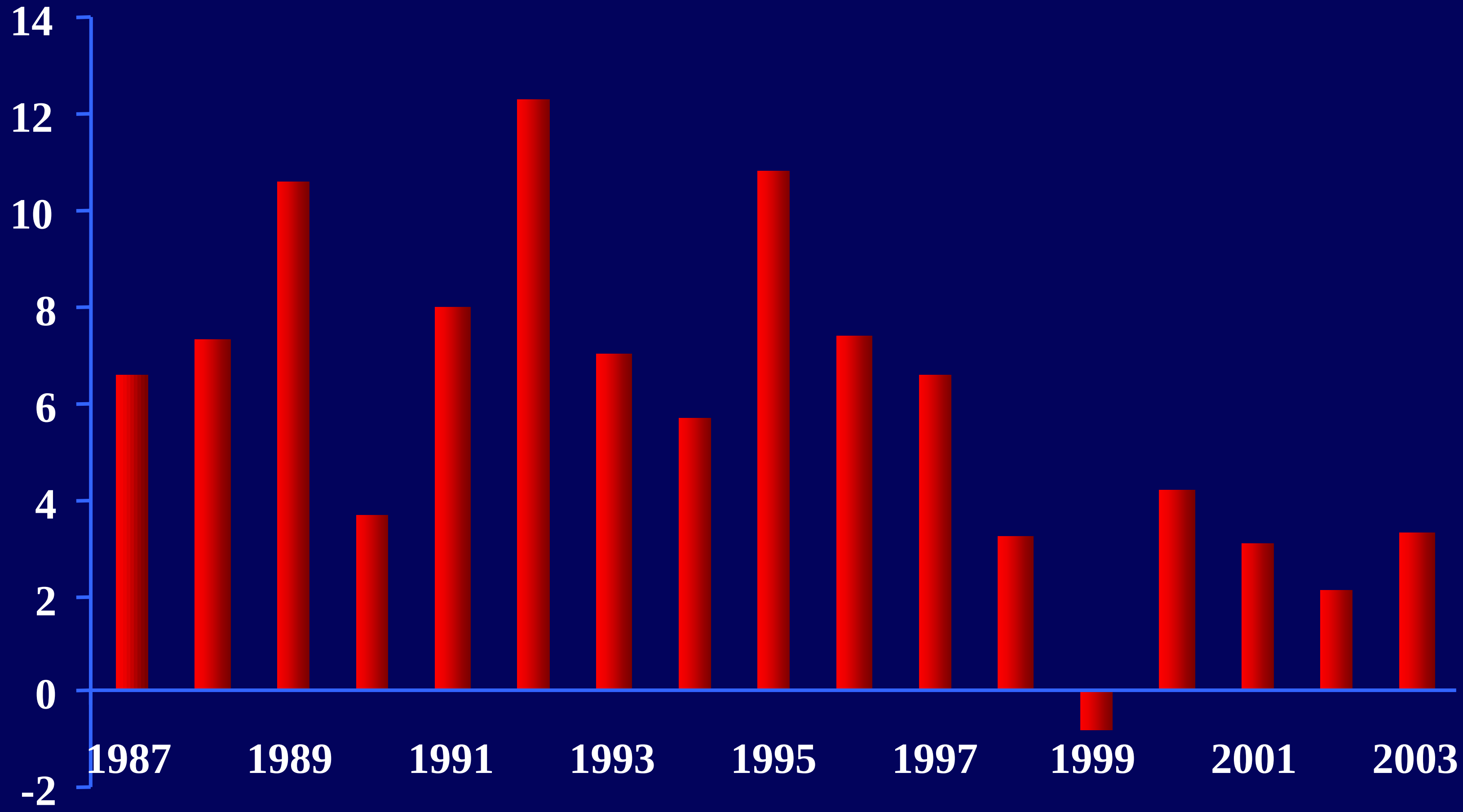
Inflation Targets and Inflation Rate

(y-o-y % change)



GDP Growth

(%)



4. Estimated Effects of Chile’s Free Trade Agreements

4. Estimated Effects of Chile's FTAs

- How do Free Trade Agreements affect the Chilean economy?
- Main benefits include:
  - ✓ Lower import tariffs: cheaper goods;
  - ✓ Easier market access for Chilean exports;
  - ✓ Higher TFP: effects of economic cooperation on local R&D, larger exposure to technical progress, more technical progress due to better property-rights protection;
  - ✓ Lower country risk because of more stable rules of the game.

4. Estimated Effects of Chile's FTAs

- And main costs are:
  - ✓ Higher government expenditure due to the more complex administration of Customs and Department of Agriculture;
  - ✓ Higher consumer prices paid on some goods due to more stringent property-rights protection rules (piracy is reduced by tougher control);
  - ✓ Higher cost due to the adoption and enforcement of tougher property rights, environmental and labor rules.

Estimated Effects of FTAs on Chile's GDP

Source	Effect considering: -Traditional Channels (1)	- Other Channels (2)	Other Channels include
Brown et al (1998), Michigan Model	0.37%	5.15%	Lower country risk and higher return on capital
Brown et al (2001), Michigan model	0.6% (3) 0.92%		- Considers US only - Considers NAFTA
Coeymans and Larraín (1992) (3)	0.26%	10.0%	Over a longer horizon, the interest rate falls and the capital stock rises.
Harrison et al (1997), (2001), (2002)	0.43%-1.23%	8.4%	Includes simultaneous agreements with the United States, European Union, MERCOSUR and others.
Hinojosa-Ojeda et al (1997) (3)	0.20%	1.3%	Positive externalities.
SIA Chile (2002)		0.5%	European Union.
Chumacero et al (2004)		1.0%	Lower country risk and higher efficiency. Agreements with United States and European Union

(1) Includes reductions to tariffs and non-tariff barriers resulting from the trade agreement.

(2) Measures the total accumulated effect of the agreement.

(3) Measures the impact of a Chile-US accord and not Chile's entry into NAFTA.

Anticipated Effects of Chile's FTAs

- Other non-measurable effects (Cabezas, 2003):
  - ✓Lower transaction costs;
  - ✓Institutional improvements and higher standards of domestic policies (governance, banking regulations, disclosure, etc.);
  - ✓Stronger government policies;
  - ✓Dispute Settlement Mechanisms in place.

5. Future Challenges for Chile in Asia and beyond

Future FTAs

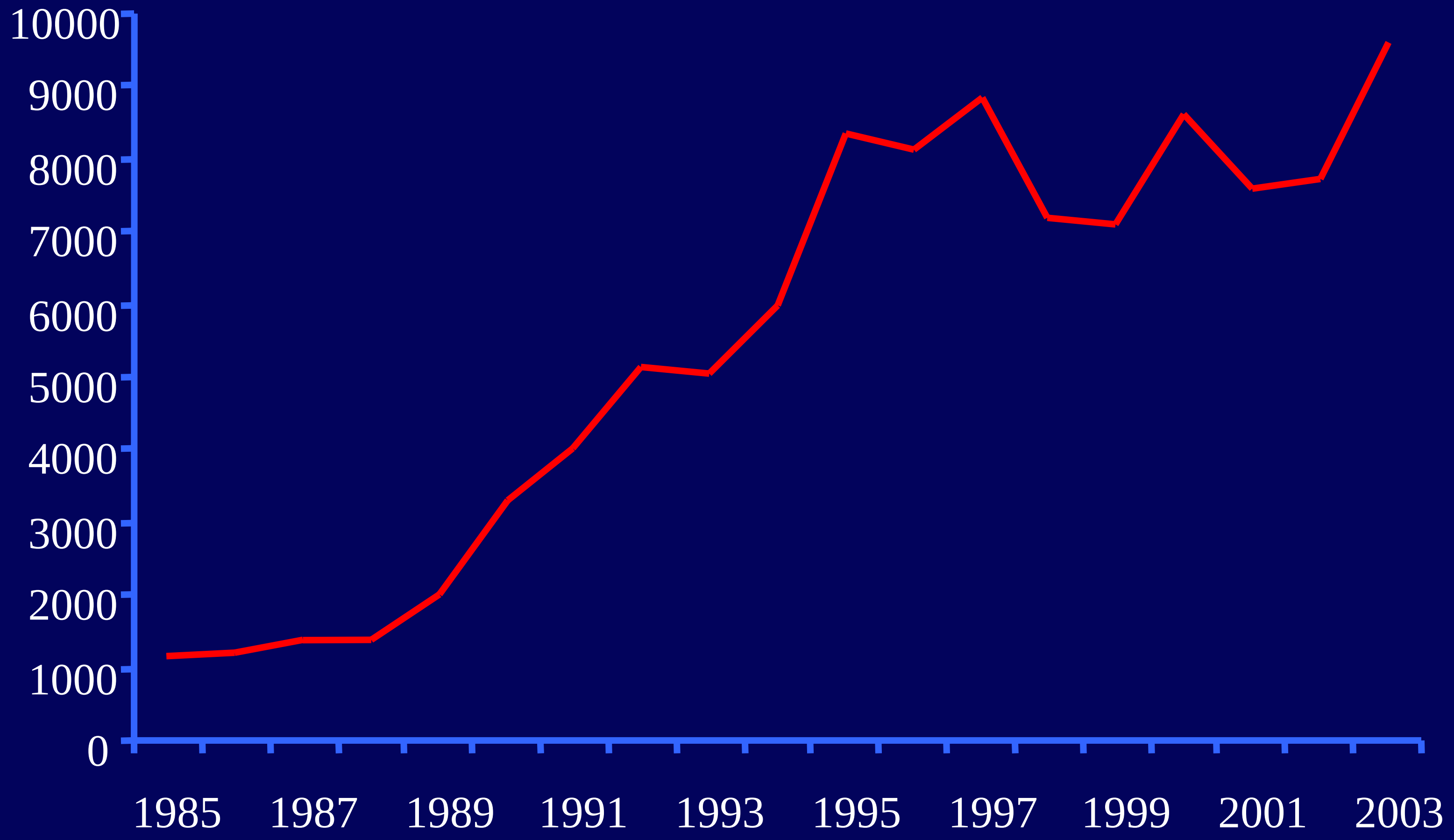
- Chile's share of foreign trade with FTA partners (at zero trade barriers) will attain 90% or more of total trade before 2010.
- But Chile faces important challenges for even deeper trade integration:
  - ✓Enhance integration within the Americas:
    - contribute to putting FTAA in place;
    - extend and deepen trade agreements;
  - ✓Improve access of Chilean exports to large Asian economies;
  - ✓Explore ways to accelerate technology transfer through broader agreements: Singapore and New Zealand (trilateral FTA).

The Challenges of APEC

- Chile's trade with Asia has risen tenfold since 1985.
- But the challenge is to intensify trade and financial links with Asian countries, bilaterally and through APEC.
- Opportunity: Chile hosts 2004 APEC meeting.
- Contribute to attain APEC's Bogor objective: free-trade and investment in the Asia-Pacific.
  - ✓by 2010: industrial countries and Chile;
  - ✓by 2020: other developing countries.

Chile's Trade with Asia

Exports + Imports (in US$ million)



The Doha Round

- As a small country Chile has much to gain from a stronger multilateral framework:
  - ✓Contribute to successful completion of multilateral trade liberalization under WTO's Doha Round.
  - ✓This requires strong, concerted resolve to push negotiations toward a successful agreement to fully liberalize, or severely limit the use of anti-dumping measures, safeguards, and other agricultural subsidies that are widespread in the U.S., Europe, and Japan.

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