



The Chilean Economy: Recent Developments and Prospects

Vittorio Corbo

Governor

Central Bank of Chile

Outline

1. Introduction

2. The Monetary Policy Framework

3. Recent Developments

4. Future Prospects

1. Introduction

1. Introduction

- Thirty years ago the Chilean economy was closed to international trade, suffered from widespread price controls, a high degree of state intervention and serious macroeconomic imbalances:
 - Fiscal deficit of about 30% of GDP;
 - Annual inflation rate above 500%;
 - Average import tariff of 105% (with great dispersion), multiple exchange rates and a lot of other restrictions to international trade (quotas, etc.);
 - Price and interest rate controls.

1. Introduction

- In a major turnaround, Chile has become a stable and very dynamic and competitive open economy.
- This has been the result of deep reforms of policies and institutions introduced during the last thirty years.

1. Introduction

- The initial reforms included:
 - In the 70s: fiscal stabilization (VAT and sharp spending reductions), liberalization of prices, opening to foreign trade, privatization of SOEs, financial liberalization, pension reform, and capital account (albeit partial) liberalization;
 - But the regulatory and supervisory frameworks of banking were not upgraded fast enough, leading to the debt crisis of the early 80s;
 - These errors were amended in the post-crisis years: new banking law and bankruptcy laws were enacted; banking regulations were updated; and there was a second wave of privatizations.

1. Introduction

- Moreover, in late 1989 the Central Bank was granted full independence and by law it was precluded from financing the government.
- Also in 1989 a successful transition to democracy was initiated while maintaining and strengthening the market economy model.
 - The three administrations since have given more weight to social policies as a way to alleviate poverty.

1. Introduction

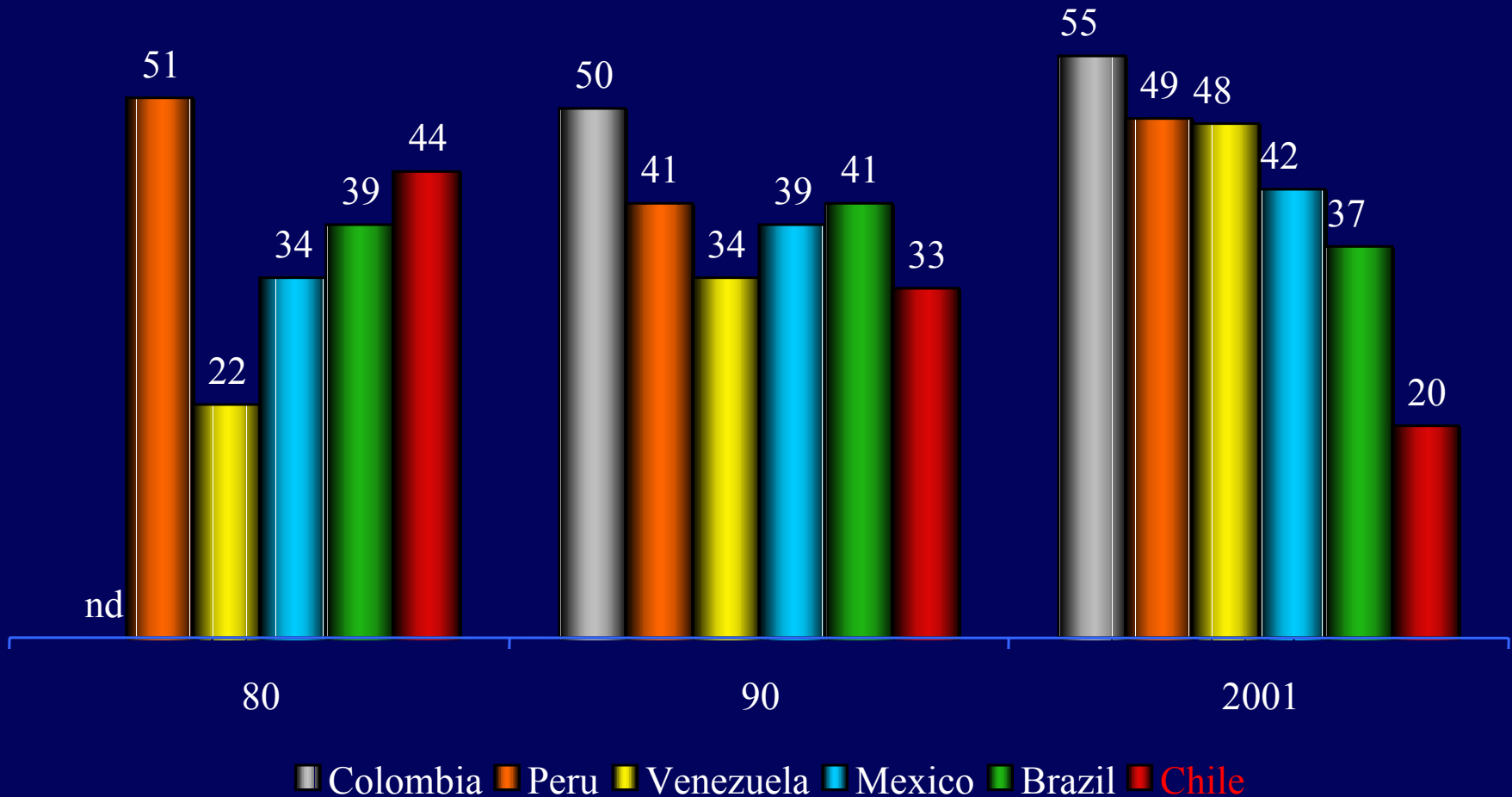
- During the 90s important reforms were introduced in many areas:
 - Competition in telecommunications (multi-carrier system);
 - Private sector involvement in infrastructure development through (BOT) concessions;
 - Deepening the integration with the world economy (unilateral tariff reductions and PTA with important countries);
 - Education reforms;
 - Anti-trust rules;
 - Adoption of Inflation Targeting.

1. Introduction

- As mentioned, due to these reforms Chile became a very stable and dynamic and competitive economy.
- The country's average annual growth rate in 1986-97, *the golden period*, reached 7.3%.
- Social indicators improved significantly, becoming one of the best in the Latin American region.

Poverty in Latin America

(% of households below the poverty line)



Source: ECLAC (2002).

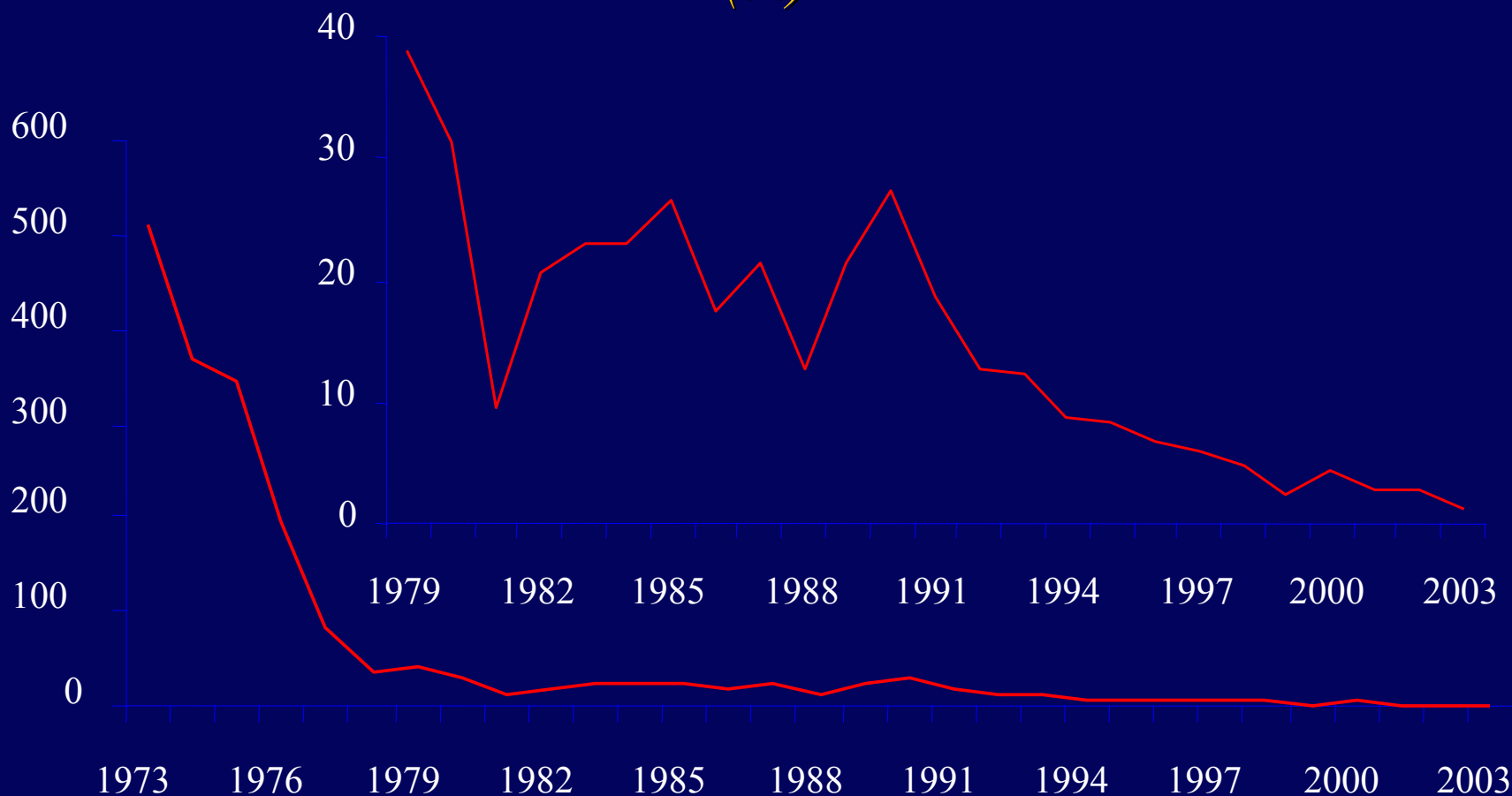
* Preliminary numbers.

1. Introduction

- Chile today has solid macro fundamentals and modern and robust institutions that allows it to accommodate adverse external shocks more easily and attain sustainable economic growth:
 - Solid financial system;
 - Solid fiscal situation with a low level of public debt;
 - Small current account deficit;
 - Low and stable inflation;
 - A consistent policy framework (fiscal, monetary and exchange rate policy mix).

Annual Inflation

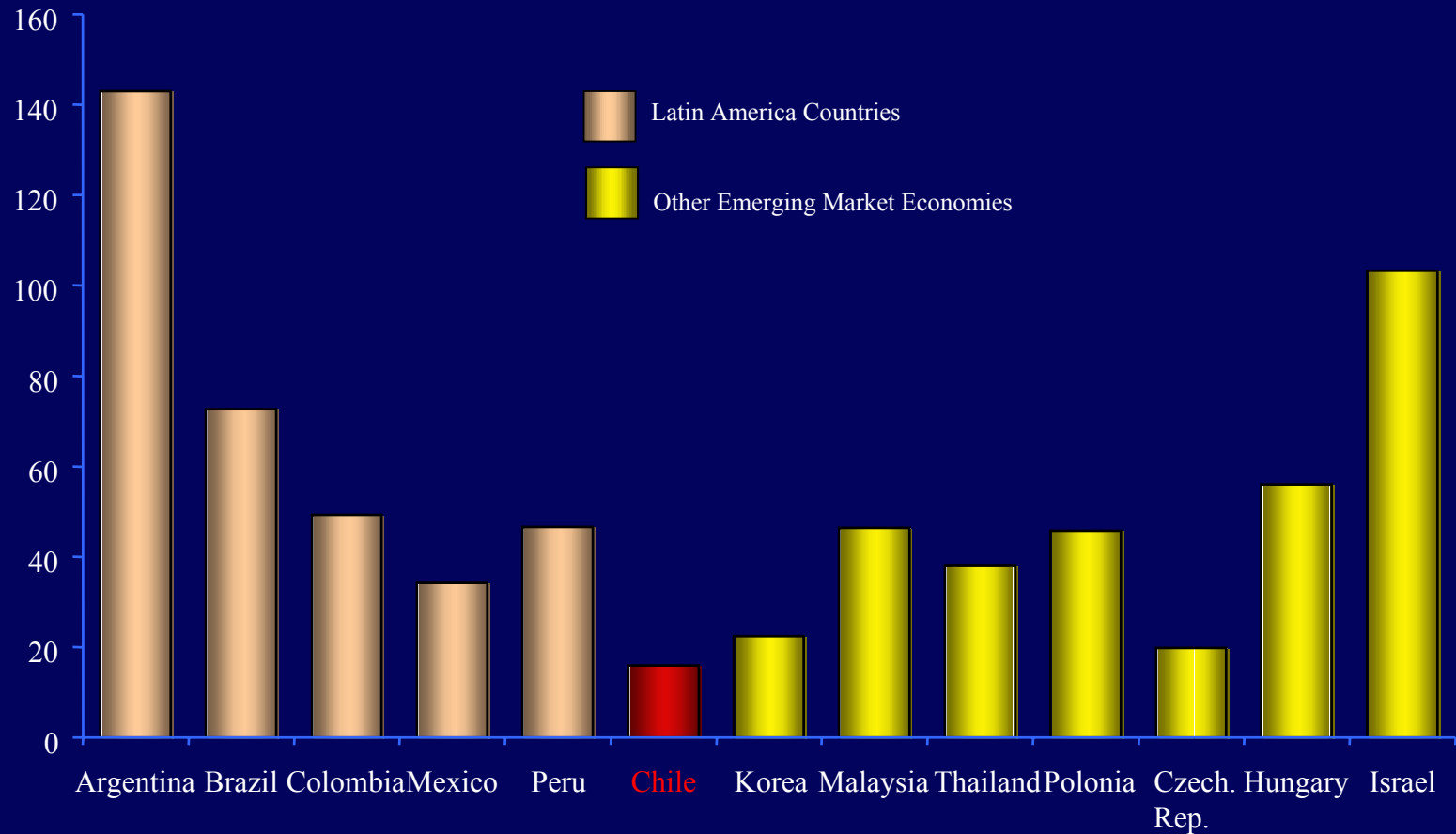
(%)



Inflation (Dec.-Dec, %)

Public Debt 2002

(% GDP)

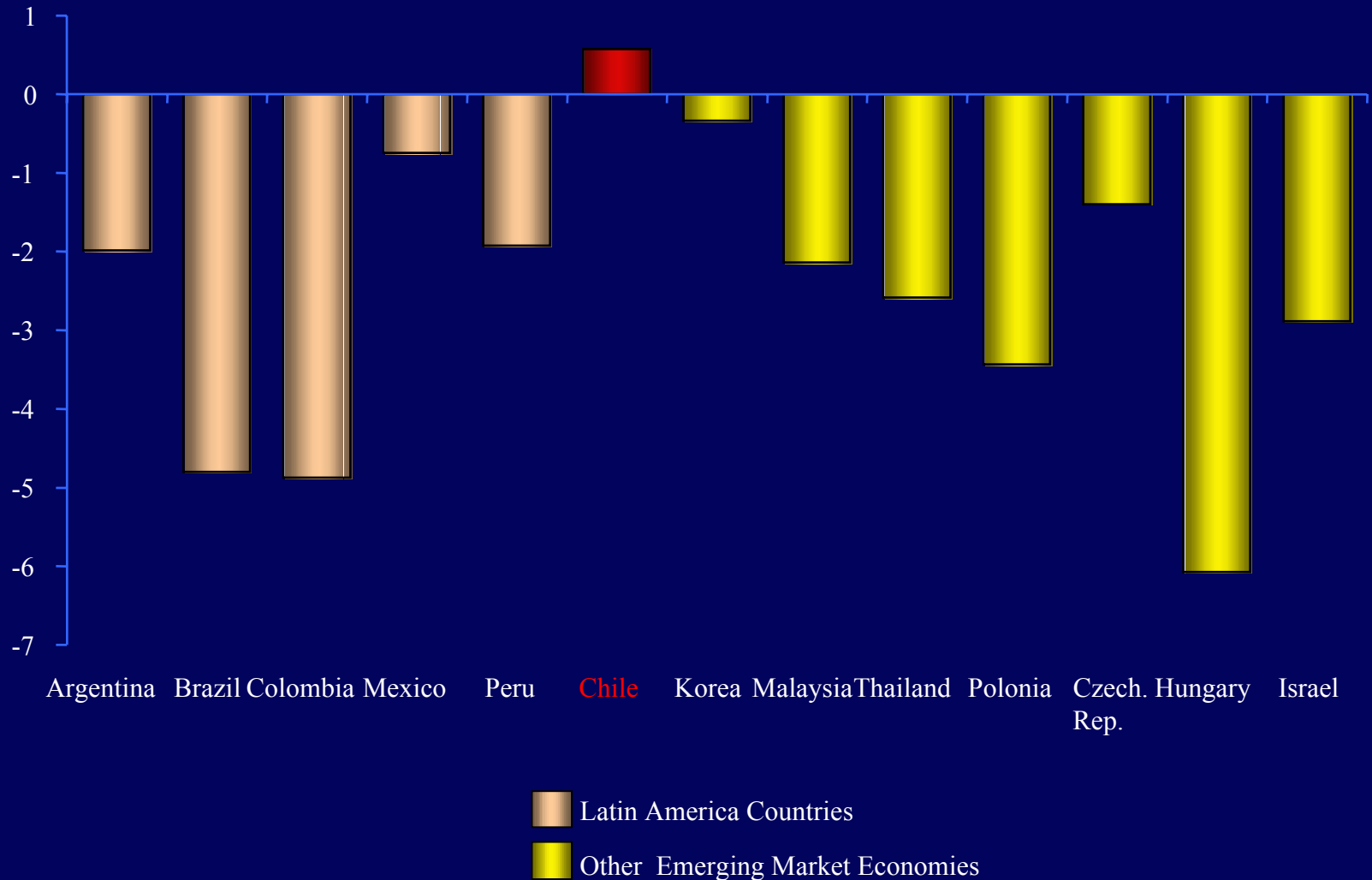


(1) Gross central government debt (excludes debt from the central bank and social security trust funds)

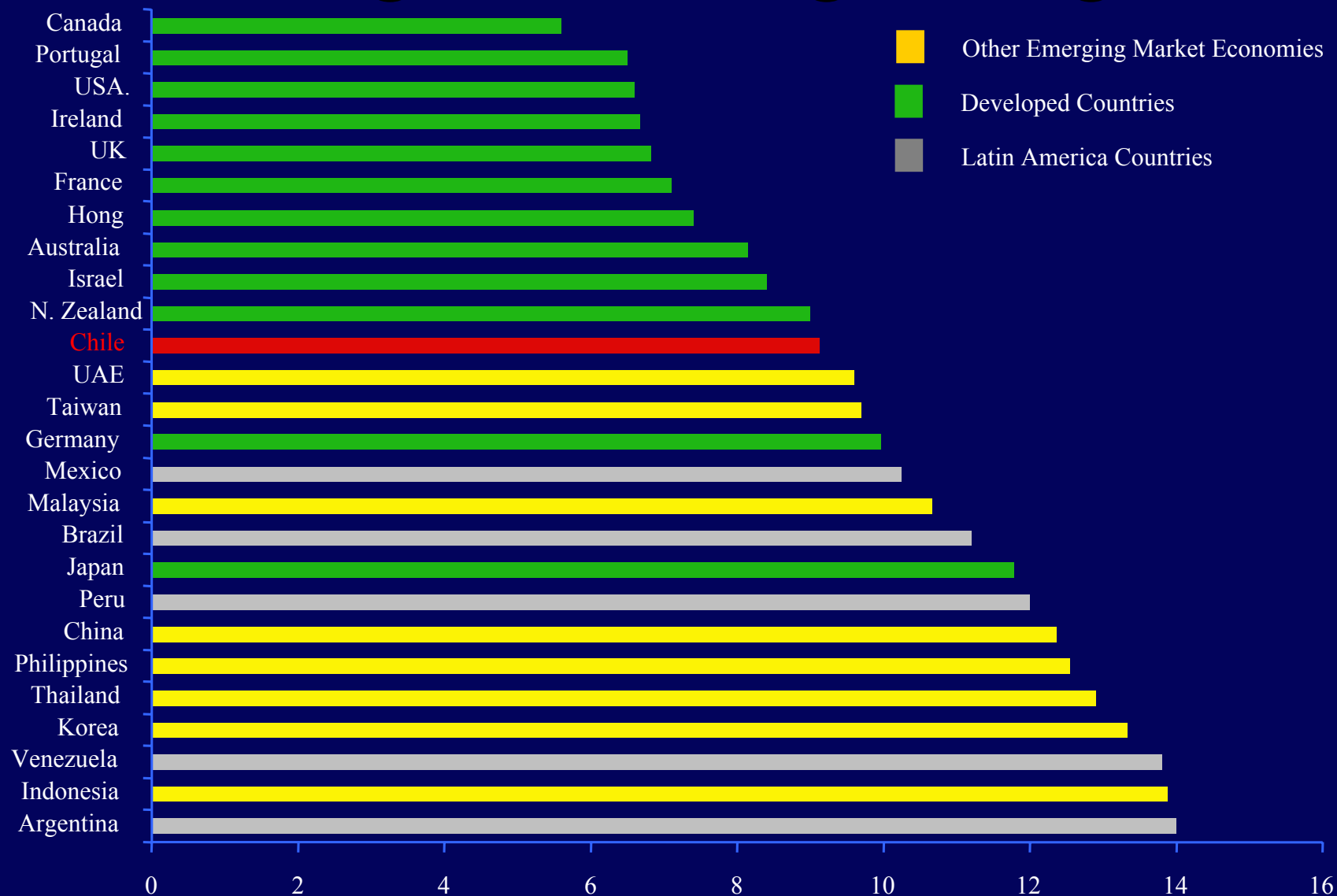
Source: Moody's April 2003, and Ministry of Finance

Fiscal Balance: Average 1995-2002

(% GDP)



Ranking of Banking Strength



Source: Moody's, March 2003.

2. The Monetary Policy Framework

2. The Monetary Policy Framework

- Since the early 90s Chile has an IT monetary framework.
- The IT framework is one of “*constrained discretion*”, that is:
 - The CB is committed to attain and maintain inflation in the target range (centered in 3% with a symmetric band of 1%) in the policy horizon (12-24 months);
 - Although in the short run inflation can fall outside the target range;

2. The Monetary Policy Framework

- But the CB has discretion to use monetary policy to ease cyclical fluctuations in output and employment, **if and only if** the attainment of the inflation target is not in jeopardy –when forecast and expected inflation are around the target.
- For this to work the CB must have a good reputation built on a good track record of fulfilling its target.

2. The Monetary Policy Framework

- How does monetary policy work?
 - The CB through its communiqués and especially its actions builds a reputation regarding its commitment to use monetary policy to attain and maintain a low and stable inflation.
 - Two elements are very important to this end:
 - Credibility
 - Transparency

2. The Monetary Policy Framework

How does monetary policy work?

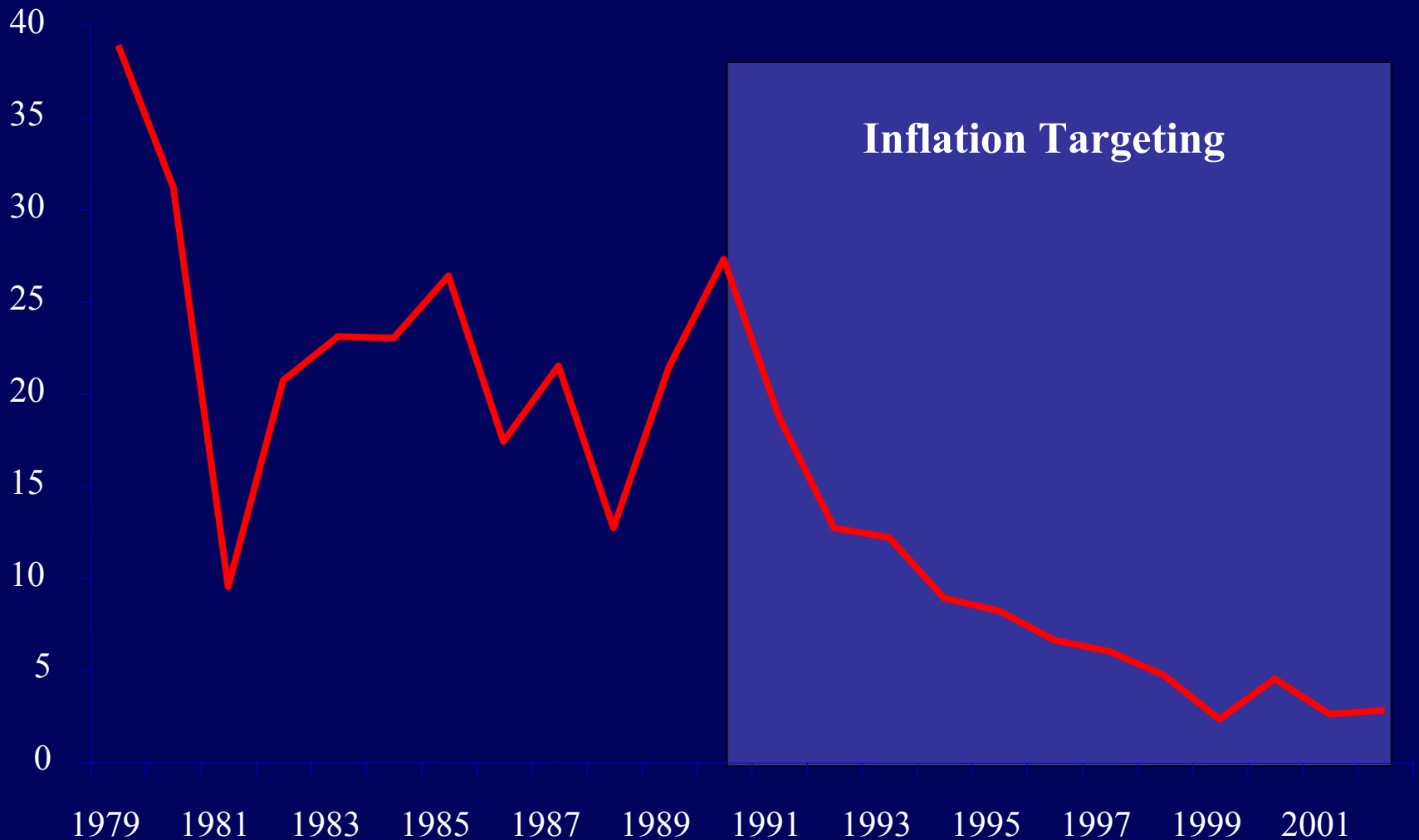
- The CB modifies interest rates whenever it foresees a high probability that inflation will exceed the target range, for a while, in the policy horizon in any direction.
- Since monetary policy affects inflation with a lag, the CB needs to anticipate cyclical fluctuations.
- For this, reliable forecasts are needed, which entails the capacity to evaluate the size and persistence of different shocks (highly qualified staff is needed).

2. The Monetary Policy Framework

- This —*constrained discretion*— is what the Central Bank of Chile has successfully done for more than a decade.
 - During this period annual inflation fell from near 30% to the low one-digit level.

Annual Inflation

(%)



2. The Monetary Framework

- Proof of the latter is that since mid 2001 the Central Bank has cut interest rates significantly (50 b.p. each time in the last two monthly MP meetings) and both actual inflation and expectations have remained stable around the target in a 12 to 24 months horizon.
- Chile vividly illustrates how credibility in the authorities' capacity to wisely and responsibly conduct economic policies can bring great benefits (in Chile's case fiscal policy is also an example).

2. The Monetary Framework

- In all this the independence of the Central Bank plays an important role: the CB needs autonomy to fulfill its commitment of attaining and maintaining low inflation.
- But this is not all: fiscal responsibility is also a necessary condition (otherwise higher interest rates will be necessary to keep inflation within the target range).
- In the case of Chile the 1% structural surplus fiscal rule enhances market confidence.

3. Recent Developments

3. Recent Developments

- Chile is an open economy whose performance in the short-run depends closely on developments in the world economy.
 - Although its long run growth depends on domestic factors.
- Thanks to its good fundamentals and the high credibility in its policies, Chile is today better prepared than in the past –and than other emerging market economies– to accommodate shocks: i.e., the Asian crisis had only mild effects.

3. Recent Developments

- This is the result of the reforms and policies of the last three decades.
- And in recent years Chile has continued strengthening its macro and institutional framework, thus, improving its resilience to shocks:
 - A fiscal rule of a 1% structural surplus was adopted in 2001;
 - The exchange rate band was abolished in 1999, thus consolidating the float and strengthening the Inflation Targeting Monetary Framework;

3. Recent Developments

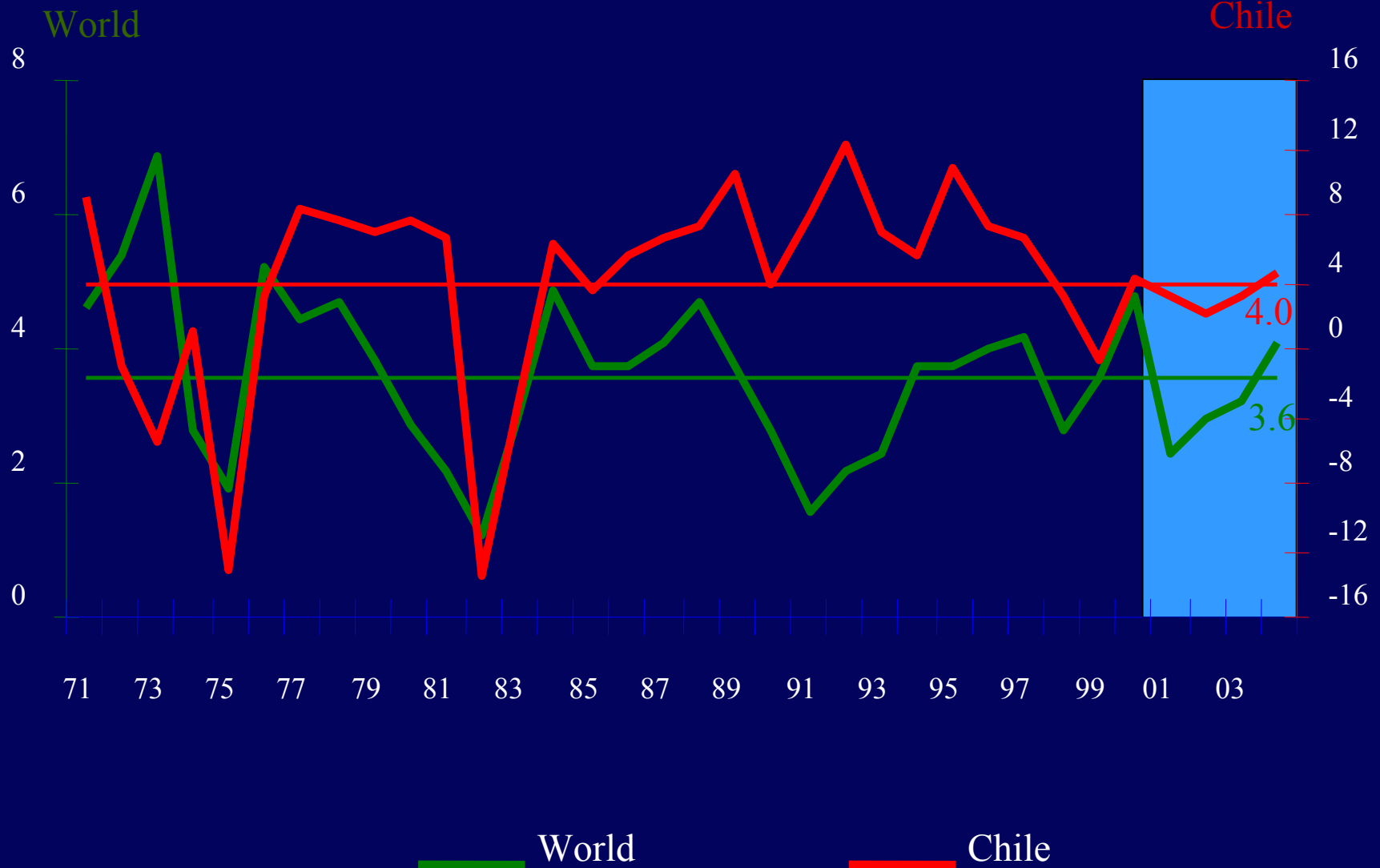
- The opening of the capital account was completed in 2001 with the abolishment of all remaining capital controls;
- FTAs were signed with the EU in 2002, and with South Korea (waiting for congressional approval) and the US in 2003;
- Reform to Capital Markets;
- The State Reform establishing a career path for public servants based on merits, and regulating the funding for political parties.

3. Recent Developments

- Despite, Chile has suffered the effects of the global slowdown of 2000-02 as well as from the crisis in neighbors countries.

World and Chile's Growth 1971-2004

(%)



Source: IMF

3. Recent Developments

- The global slowdown affected the performance of the Chilean economy, although domestic policies have also played a role.
 - The policy response to the financial turmoil in 1998 drove interest rates to very high levels, with little exchange rate adjustment, causing distress in some sectors.

3. Recent Developments

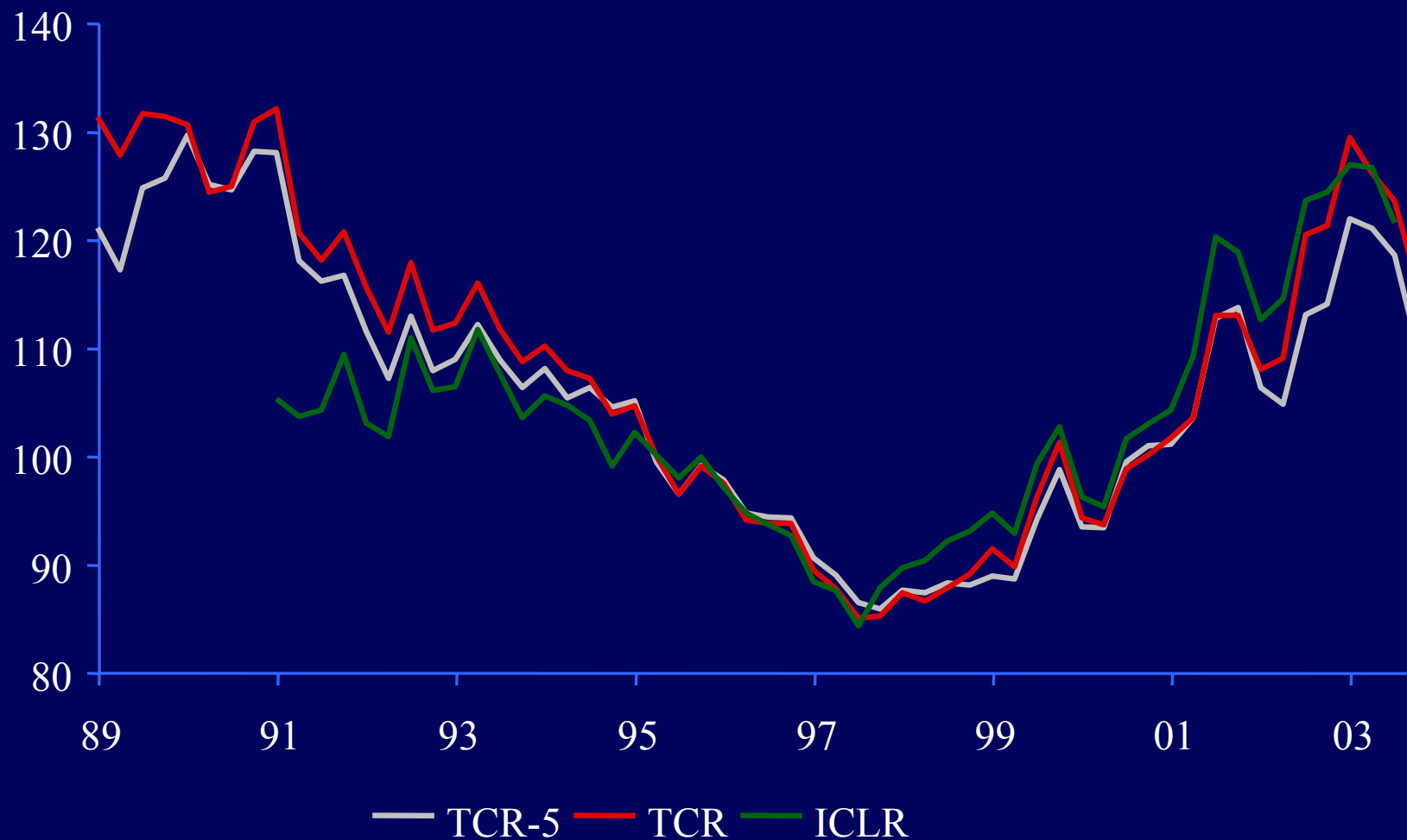
- In the past year we began to see an improvement in the global economy which led to a recovery in Chile's economic growth.
 - Terms of trade improved, specially copper;
 - Regional uncertainty has receded;
 - International financial conditions have improved.

3. Recent Developments

- During the last twelve months, the peso has experienced an important appreciation with respect to the dollar and also multilaterally.
- Many factors are behind this appreciation:
 - The sharp depreciation of the US dollar in international markets;
 - The improvement in the regional financial situation (Brazil);
 - The change in the fundamentals that determine the real exchange rate (terms of trade, growth prospects).

Real Exchange Rate

(average 1995=100)



Nominal Exchange Rate

(December 2001=100)



Nominal Exchange Rates: Accumulated Variation with respect to the US dollar

(in % as of January 22, 2004)

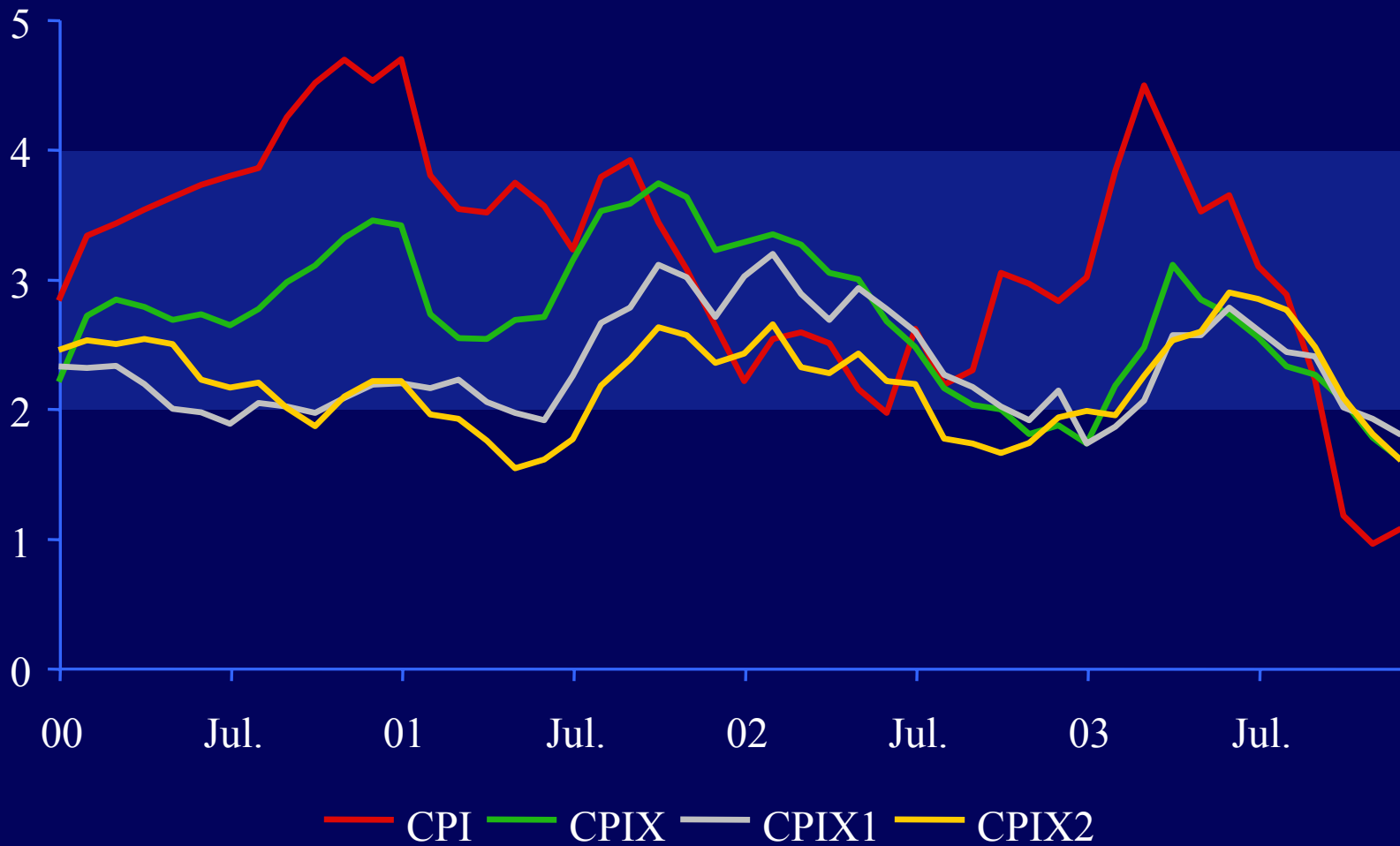
	Dec 2000	Dec 2001	Dec 2002	Dec 2003
Argentina	190,0	189,5	-13,8	-1,4
Brazil	45,5	22,8	-19,9	-1,9
Mexico	15,1	20,9	6,8	-1,4
Chile	-0,8	-13,9	-21,0	-4,0
Japan	-7,3	-19,5	-10,8	-0,9
India	-2,8	-6,0	-5,5	-0,6
Australia	-28,2	-34,5	-27,8	-3,5
N. Zealand	-34,5	-38,5	-22,6	-2,9
South Africa	-6,6	-40,8	-17,4	5,5
Canada	-13,6	-18,7	-17,6	0,2
Sweden	-23,8	-31,5	-17,4	-0,2
Euro Zone	-25,8	-30,0	-17,5	-0,9

3. Recent Developments

- With regards to inflation, it finished the year below the target range due to lower costs for firms and the appreciation of the peso.
 - The latter led the CB to sharply cut interest rates to 1.75%, its lowest level ever.

Inflation

(12 months variation, %)



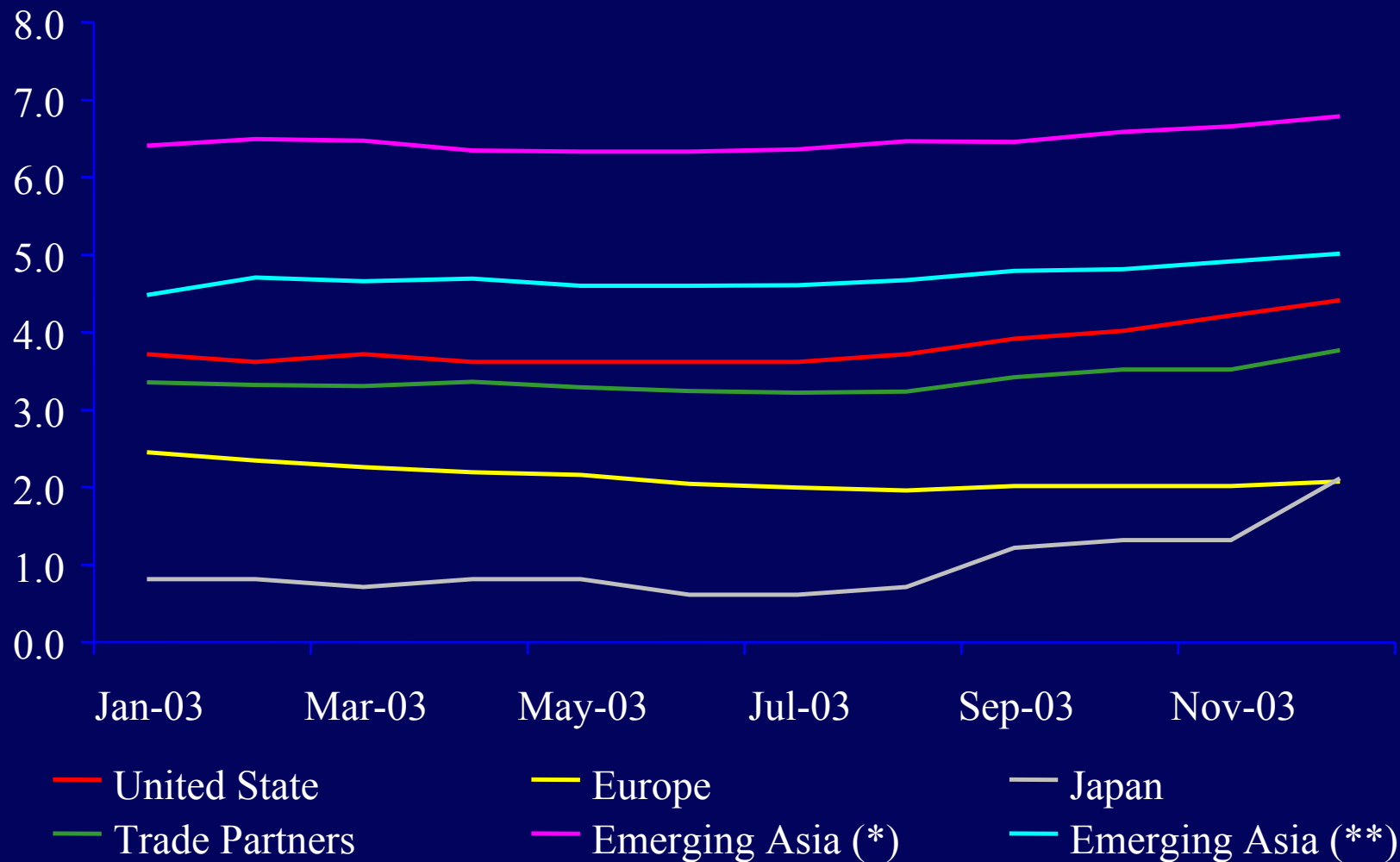
4. Future Prospects

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- Future prospects of the Chilean economy, in the short run, are closely linked to world economic activity.
 - The strong fundamentals (e.g. low public debt and low CAD) and recent trade agreements should allow for a quick recovery under more favorable conditions.
- Since mid 2003 market analysts have adjusted upwards their projections for Chile's main external markets.

Growth Forecast 2004

(Made in the indicated month)



(*) incl. China and India. (**) excl China Japan and India.

Source: Consensus Forecasts

4. Future Prospects

- As a result, prospects for the world economy look much better now than they did two years ago.
- And with that the prospects for the Chilean economy have improved significantly.
- In addition, the current monetary policy stance –aimed at pushing inflation towards the 3% central target– supports a faster recovery.

4. Future Prospects

- All in all, despite these risks, the Central Bank of Chile's forecasts for 2004 are:
 - Economic growth between 4.5% and 5.5% (up from 3.2% in 2003);
 - Annual inflation rate below the central value of the target range;
 - A small current account deficit (below 1% of GDP).

Activity Forecasts

(% Real annual variation)

	2001	2002(p)	2003(e)	2004(f)
GDP	3.1	2.1	3.2	4.5 - 5.5
National Income	1.8	3.1	3.3	6.6
Domestic Demand	2.1	1.9	3.3	7.1
Goods and service exports	6.1	1.3	6.8	8.1
Goods and service imports	3.2	0.5	7.4	14.6
Current Account (% of GDP)	-1.7	-0.8	-0.5	-0.4

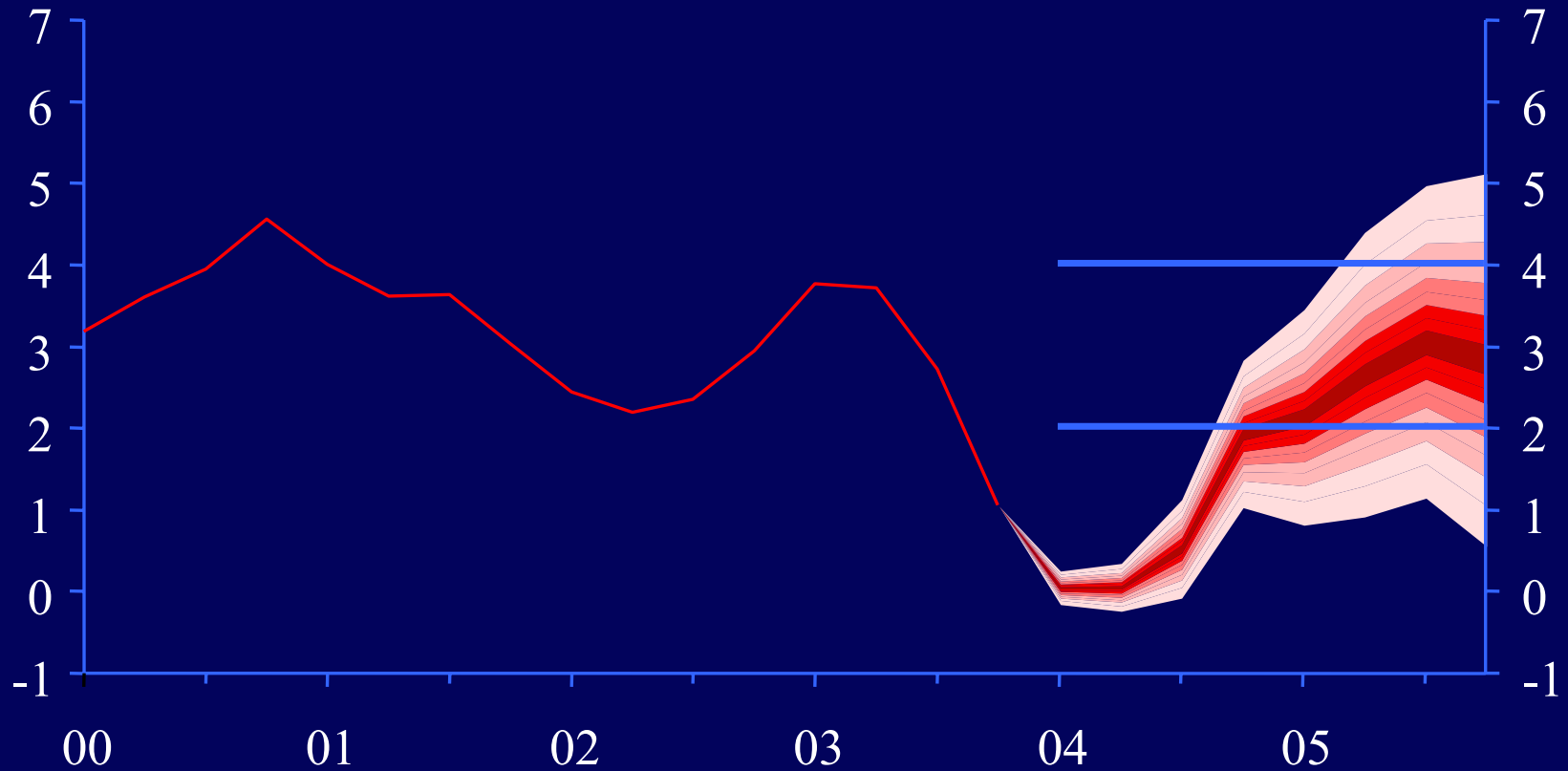
(p) Preliminary

(f) Forecast

(e) Estimated

Inflation Forecast

(% variation regard the same quarter of the previous year)



4. Future Prospects

- To reach higher and sustainable growth rates, like in the period 1985-97, it is necessary to continue looking for areas where efficiency gains can occur, producing a new jump in TFP.
- Main challenges are in education, health-care, technological innovation, labor flexibility and training.
- Recent initiatives undertaken by the government show a clear intention to continue improving in these areas.

