



The New Global World: Challenges and Opportunities for a Small Open Economy

JULY 1st, 2005

Vittorio Corbo
Governor

Outline

1. Introduction
2. Chile in the new Global World
3. Outcomes of Chile's Integration into the World Economy
4. Challenges facing Chile in a Global World
5. Conclusion

1. Introduction

A faint, circular watermark of the Bank of Canada seal is visible in the background. The seal features an eagle with spread wings, perched on a branch. The words "BANK OF CANADA" are inscribed around the perimeter of the seal, and the word "CENTRAL" is visible at the top.

1. Introduction

- Three main developments are shaping the world economy today:
 - ▲ The liberalization of trade;
 - ▲ The liberalization of financial markets;
 - ▲ The progress in attaining macro stability.

1. Introduction

- Factors boosting the liberalization of trade:
 - ▲ Reduction of tariff and non-tariff barriers in successive GATT (now WTO) rounds;
 - ▲ Integration to the world economy of former socialist countries, plus China and India;
 - ▲ Advances in macro stabilization and in market oriented policies in a growing number of countries;
 - ▲ Deregulation and technological innovation, that have further reduced transportation, communication and information costs.

1. Introduction

- The liberalization of financial flows has been facilitated by deregulation, the increased macro stability and the revolution in IT and communications.
- The progress in macro (price) stability around the world has been the result of advances in macro theory, and the policy response to bad experiences in the 70s and 80s.
- As a result of these developments, the world economy is much more integrated today.

2. Chile in the New Global World

2. Chile in the New Global World

- Chile has participated also in these developments.
- Trade liberalization began in the mid-seventies and continues until today:
 - ▲ Tariff and non-tariff trade barriers were reduced/lifted in the mid-seventies;
 - Beginning in 1973, tariffs were reduced unilaterally from an average level of 105%, with great dispersion across sectors, until reaching a flat rate of 10% in 1979.

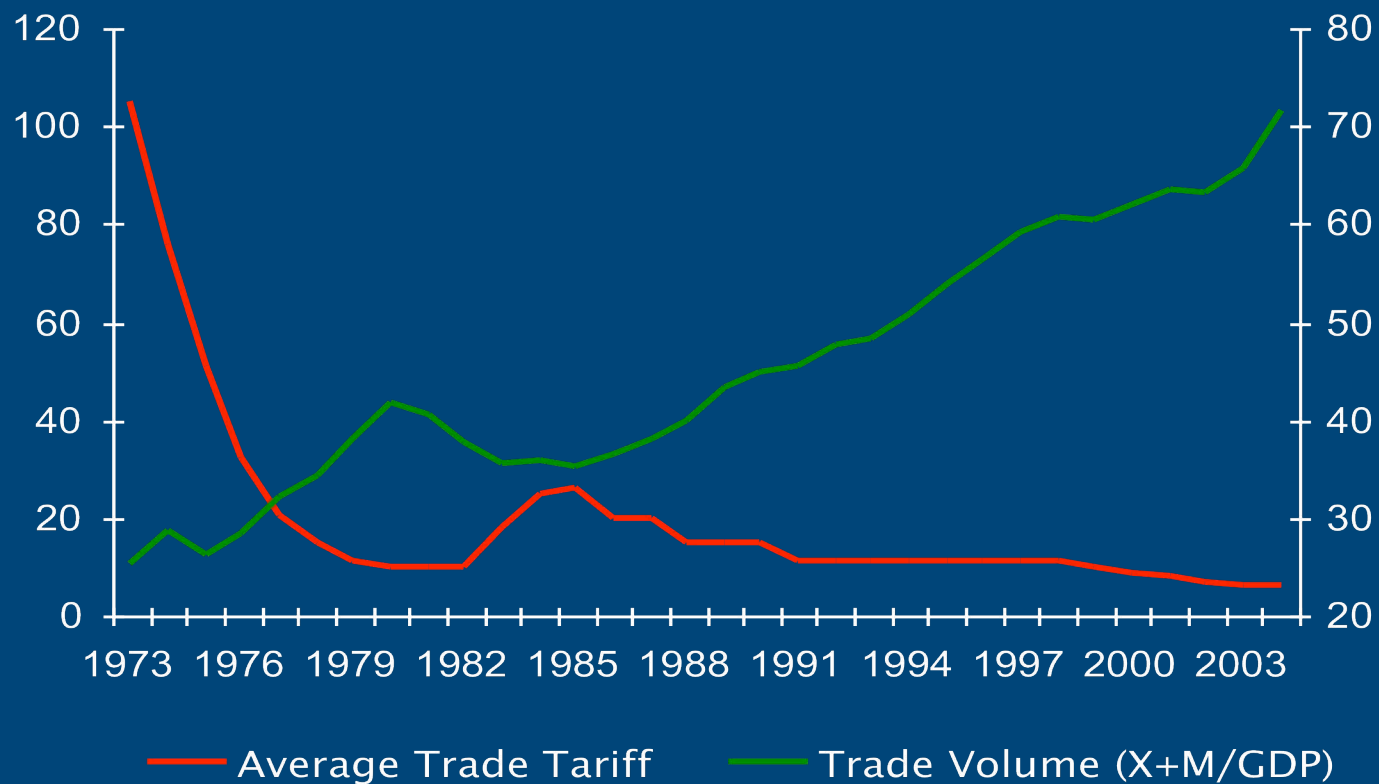
2. Chile in the New Global World

- ▲ In the early 1990s, the maximum import tariff was reduced further from 15% to 11%.
- ▲ In 1998 a new law was passed, unilaterally reducing the import tariff by 1% per year, stopping at 6% in 2003.
- ▲ This opening has been complemented in recent years with FTAs signed with important economies and regions (2002: UE; 2003: USA; 2004: Korea).

2. Chile in the New Global World



Average Trade Taxes and Trade Volume (%)



Source: Central Bank of Chile.

2. Chile in the New Global World

- Financial liberalization was initiated in the mid-seventies, although without proper institutions supporting it:
 - ▲ The lack of a sound regulatory and supervisory framework, joint with an external shock, gave rise to the financial crisis of 1981-83.
 - ▲ These errors were amended in the post-crisis years: new banking and bankruptcy laws were enacted in 1986.

2. Chile in the New Global World

- ▲ And financial system institutions have continued to strengthen:
 - 1986-1999: Deregulation and deepening of financial system:
 - Deregulation of the mutual funds industry (1994).
 - Changes in Pension Funds' investment limits (1994).
 - New General Banking Law (1997).
 - Public Offerings and Corporate Governance Law (2001).
 - Capital Markets Reform, MKI (2001).

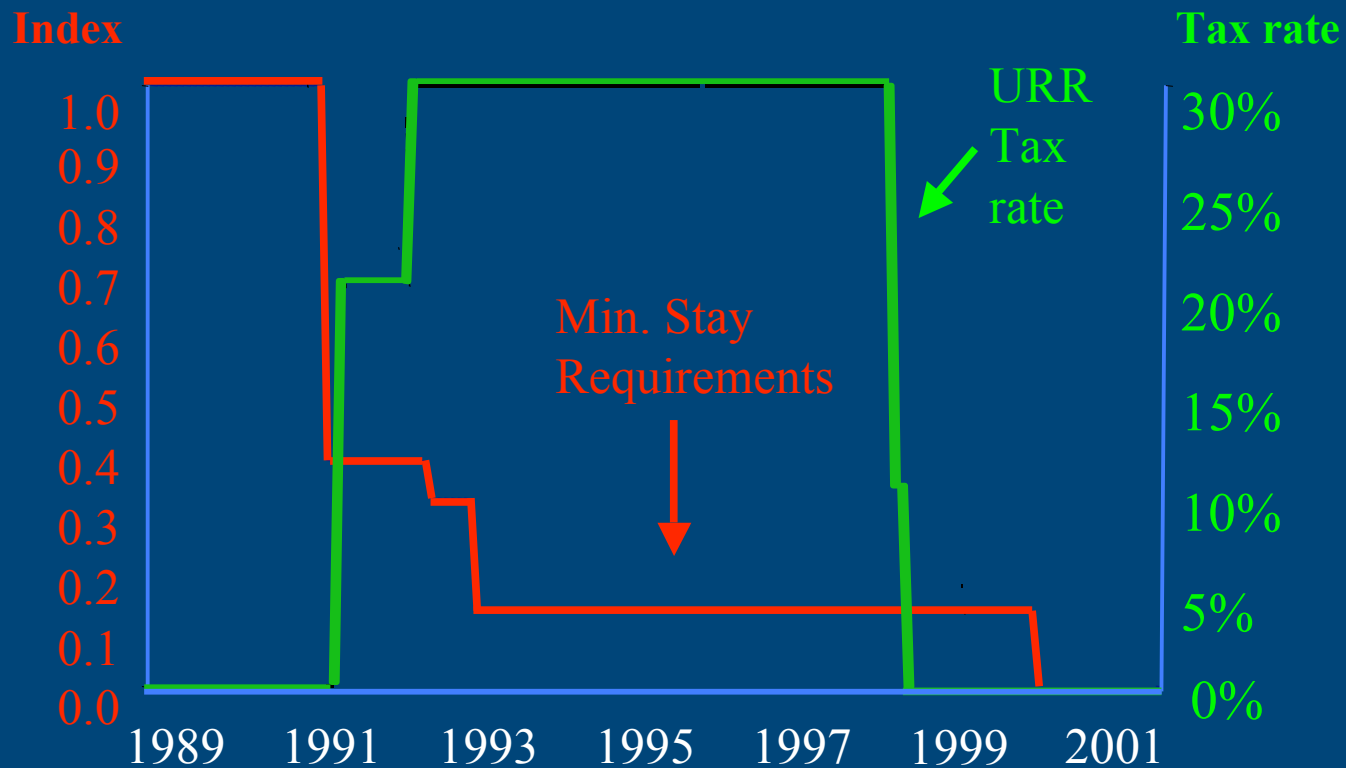
2. Chile in the New Global World

- ▲ External financial liberalization also started in the mid-seventies.
- ▲ The debt crisis years meant a temporary setback, but the trend continued in the 1990s.
- ▲ External financial liberalization was completed in 2001 with the abolition of all remaining capital controls.

2. Chile in the New Global World



Capital Controls



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

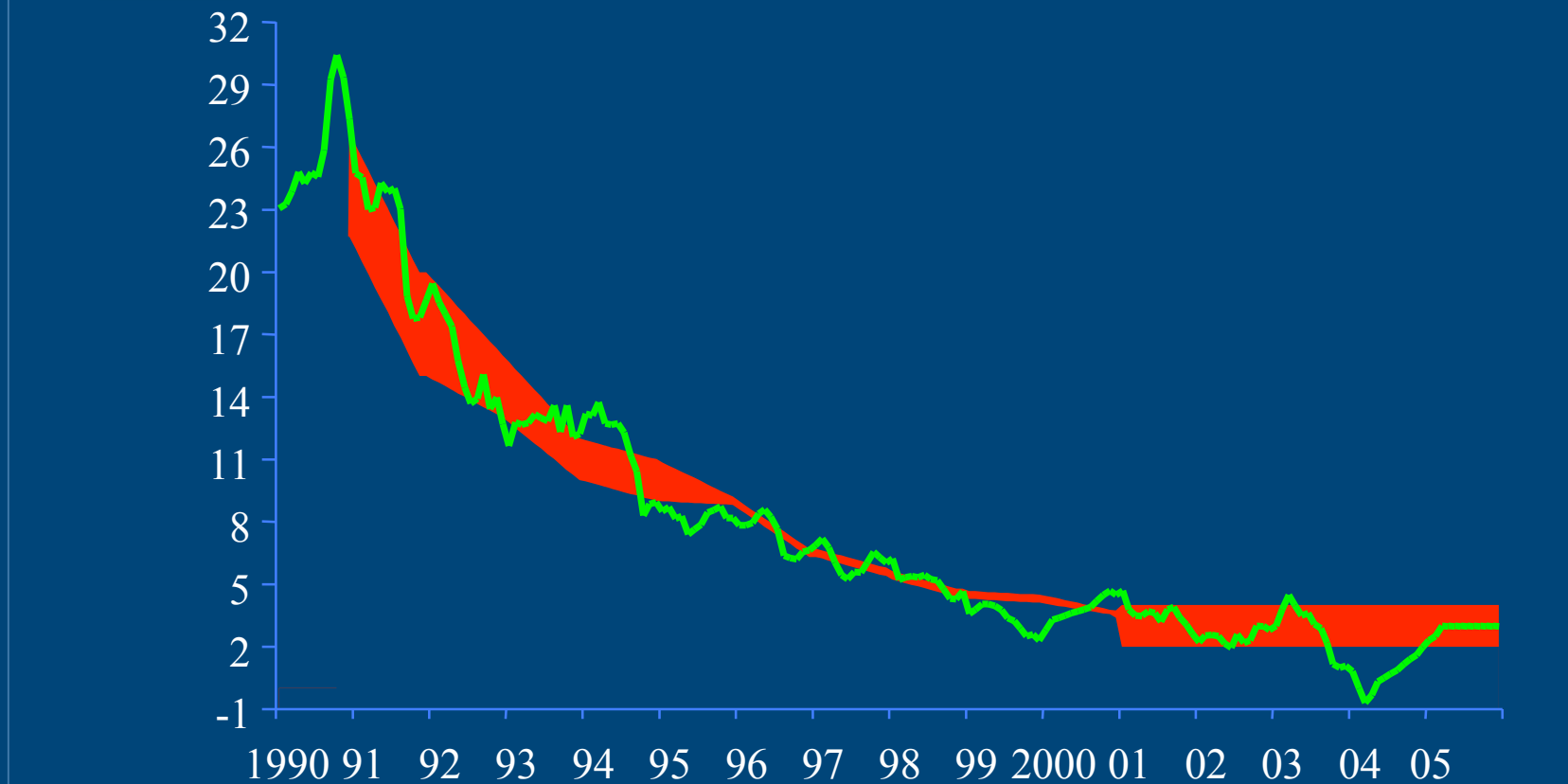
2. Chile in the New Global World

- Chile's macro stability has been built during the last thirty years and today comprises the following three pillars:
 - ▲ An independent Central Bank with an explicit mandate of achieving price stability that utilizes an IT framework and a floating exchange rate.
 - ▲ A solid fiscal situation.
 - Today Chile has a low level of public debt.
 - ▲ A robust and sound financial sector:
 - Banking system is well regulated and supervised;
 - Chile's financial system is one of the largest among emerging market economies.

2. Chile in the New Global World



Inflation Targets and Inflation Rates, 1990-2005 (y-o-y % change)

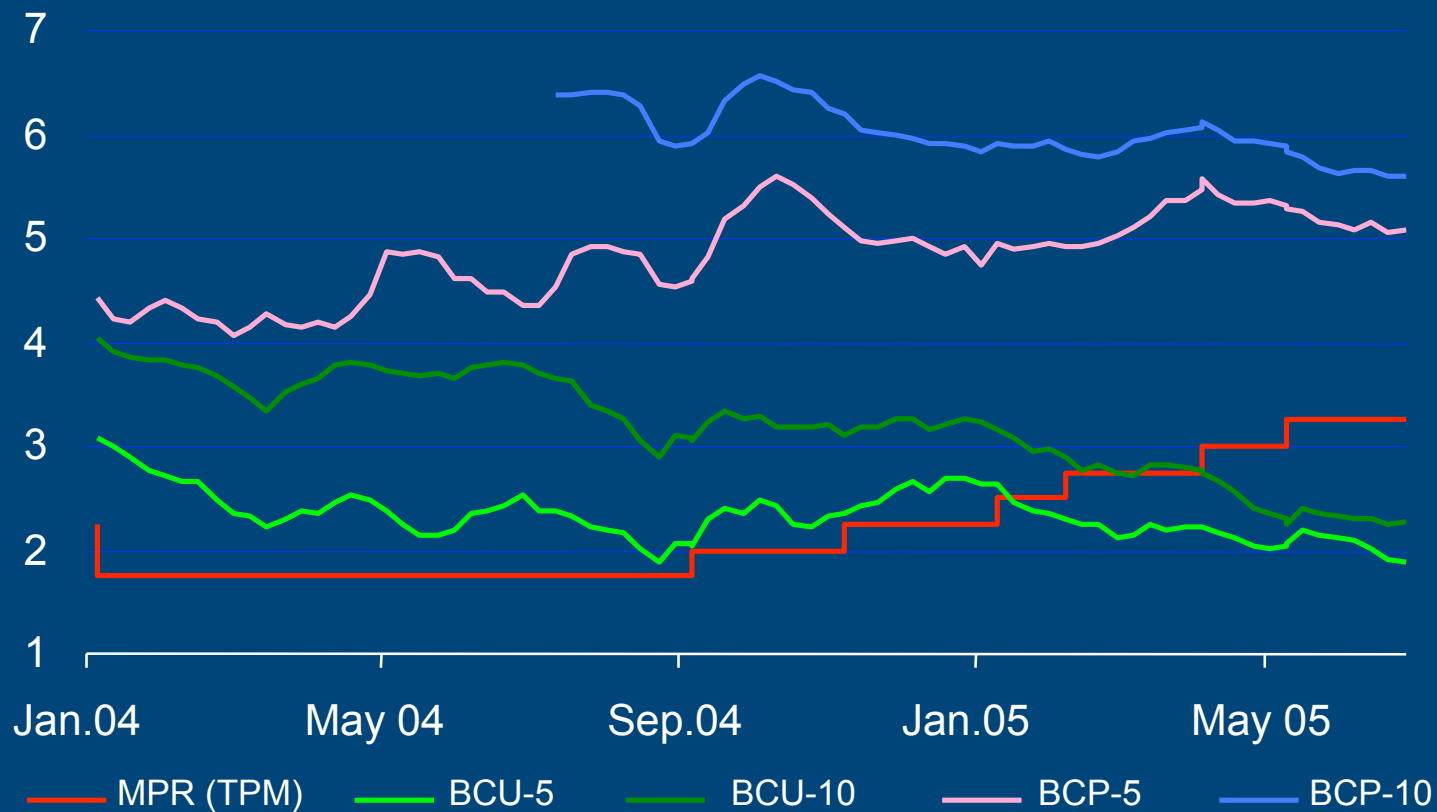


Source: Central Bank of Chile.

2. Chile in the New Global World



Interest Rate
(percentage, weekly averages)

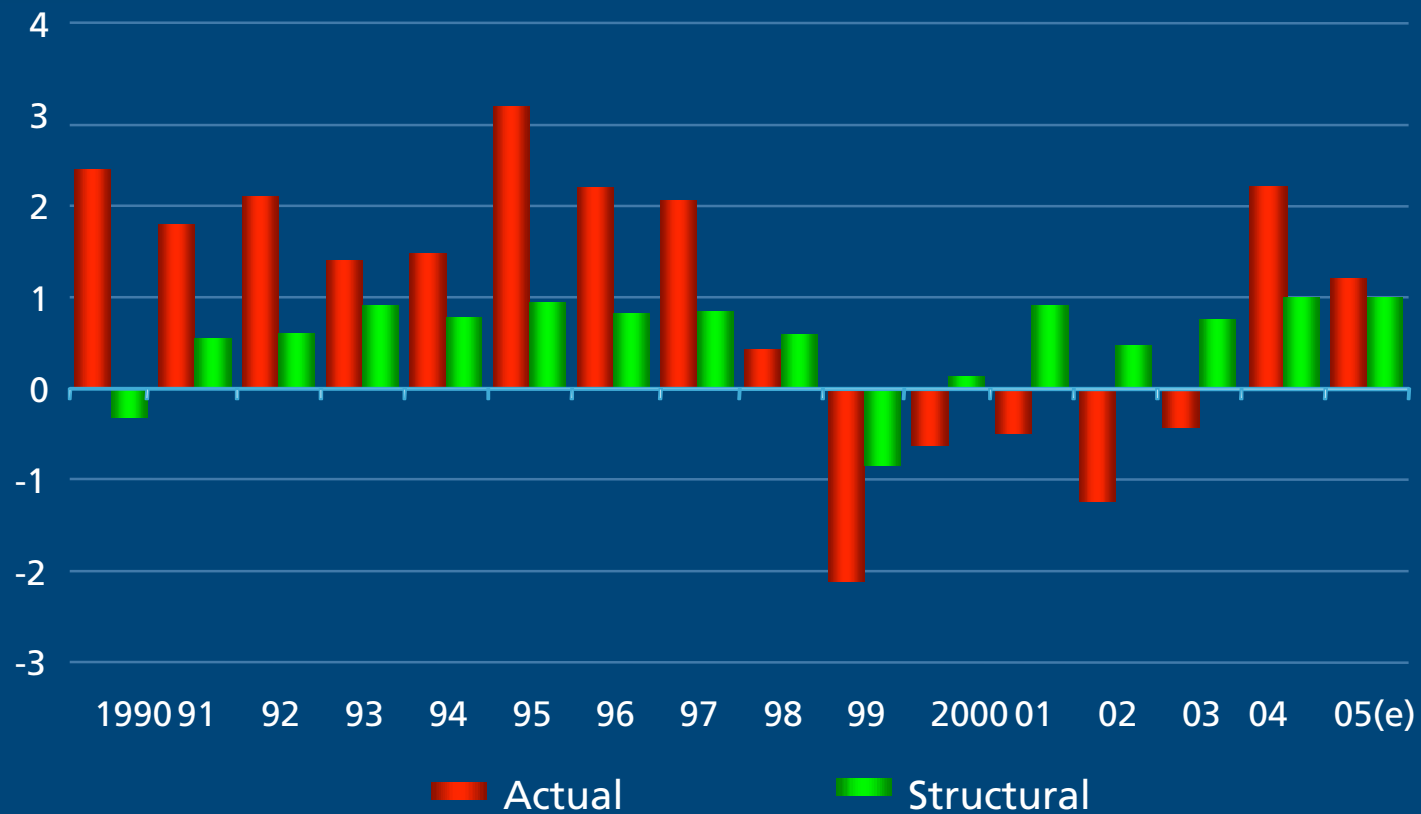


Source: Central Bank of Chile.

2. Chile in the New Global World



Chile: Fiscal Balance, 1990-2005
(% of GDP)



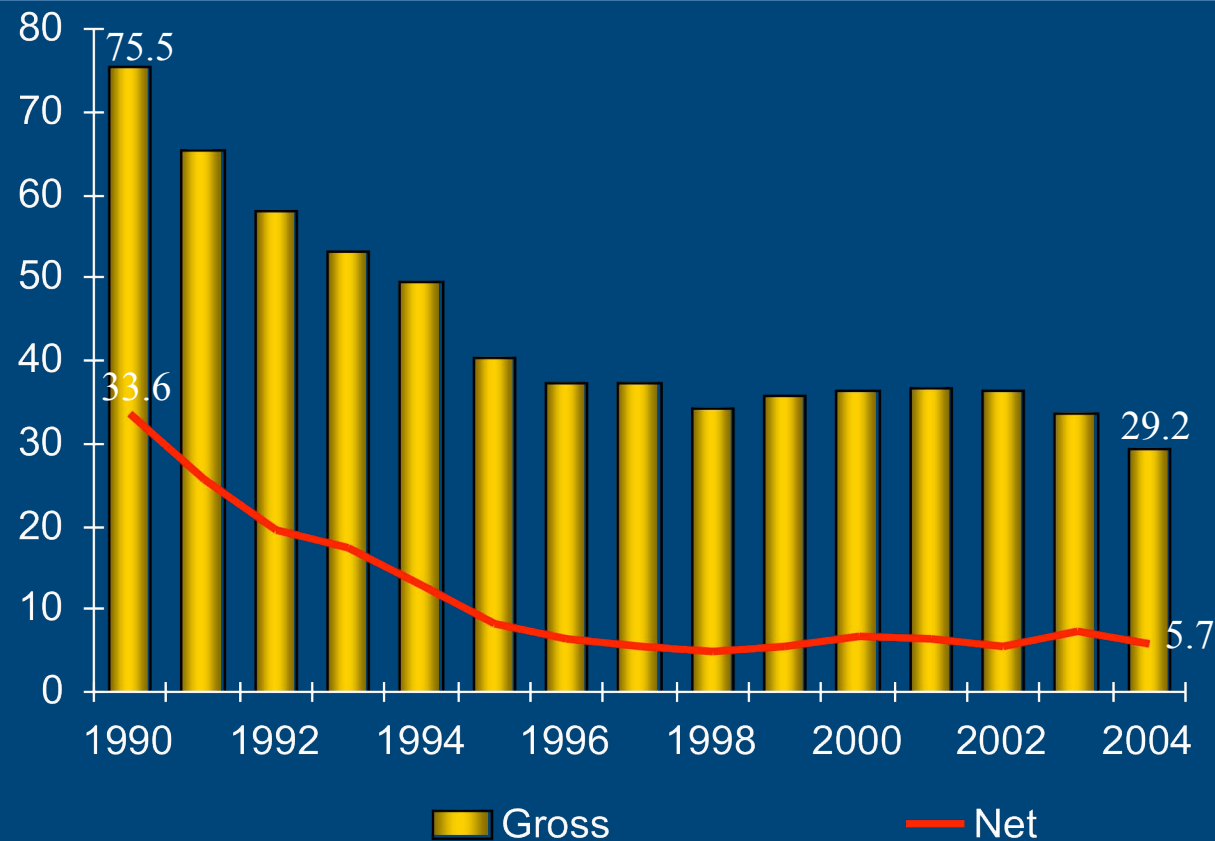
(e) estimated.

Source: Central Bank of Chile.

2. Chile in the New Global World



Chile: Public Debt, 1990-2004
(% of GDP)



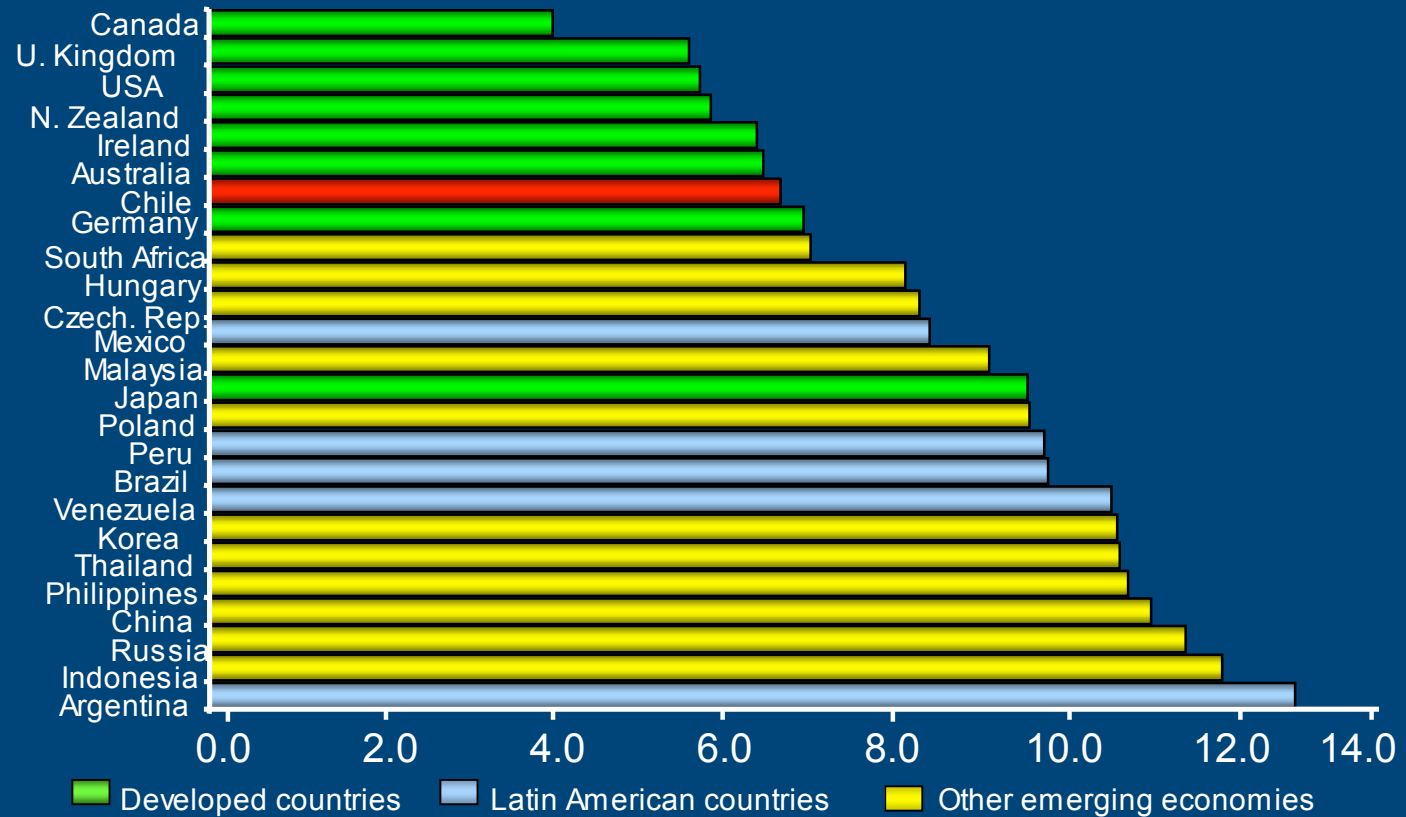
Note: Consolidated Central Government and Central Bank.

Source: Central Bank of Chile.

2. Chile in the New Global World



Banking Strength Index (May 2005)

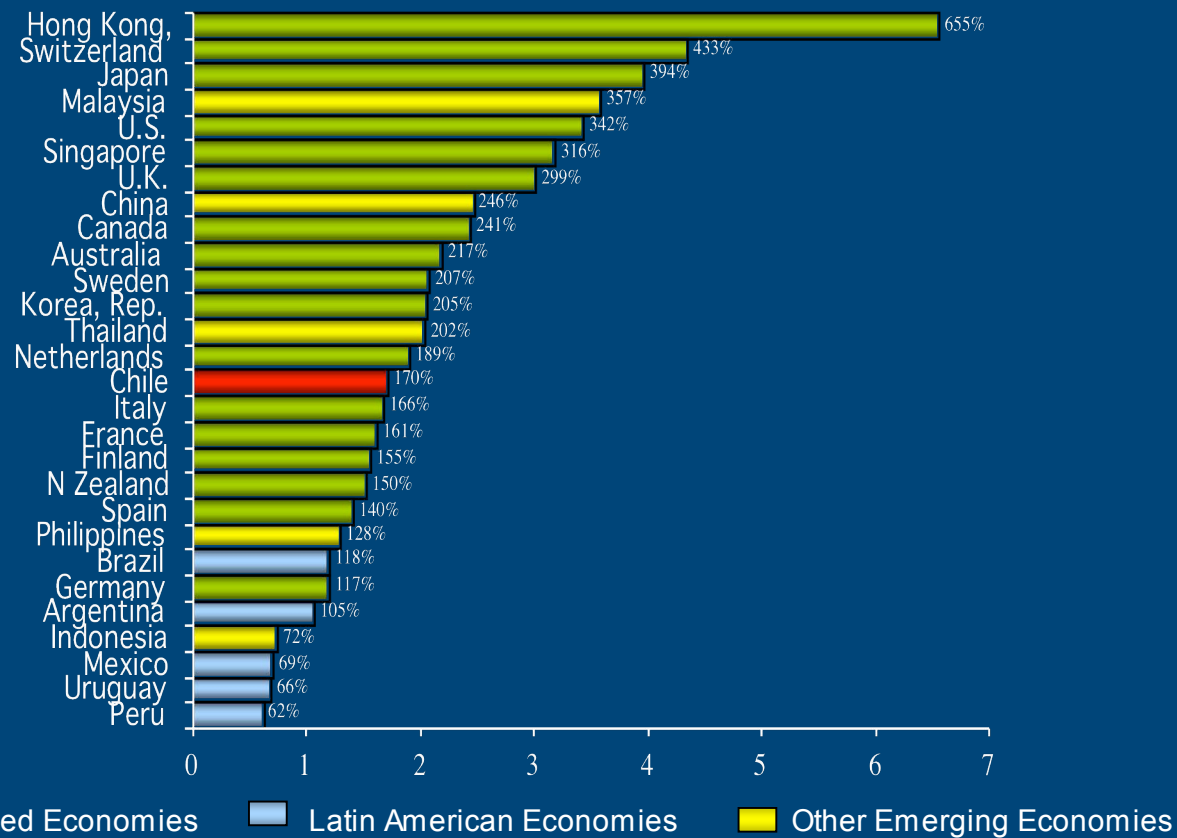


Source: Central Bank of Chile (based on Moody's Financial Strength Ranking, May 2005)

2. Chile in the New Global World



Total Financial Assets (As of 2003, %GDP)

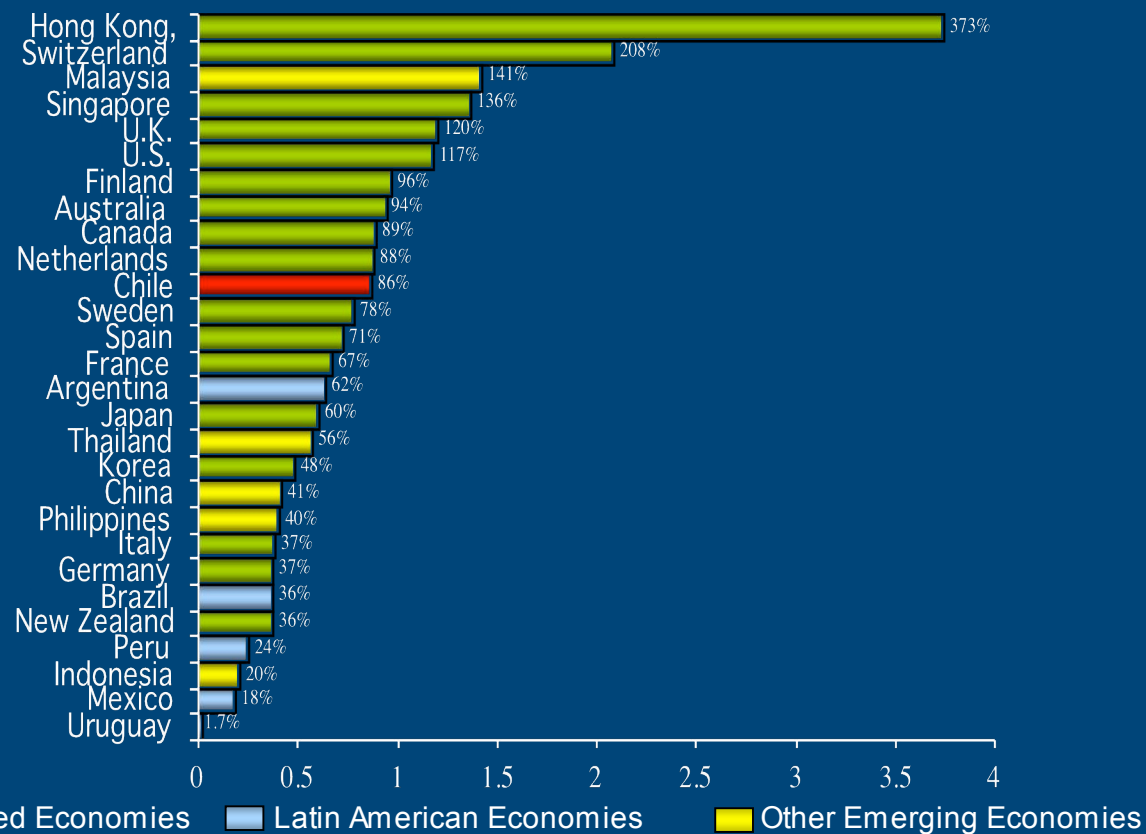


Source: Beck, Demirguc-Kunt and Levine (2005).

2. Chile in the New Global World



Stock Market Capitalization (As of 2003, %GDP)

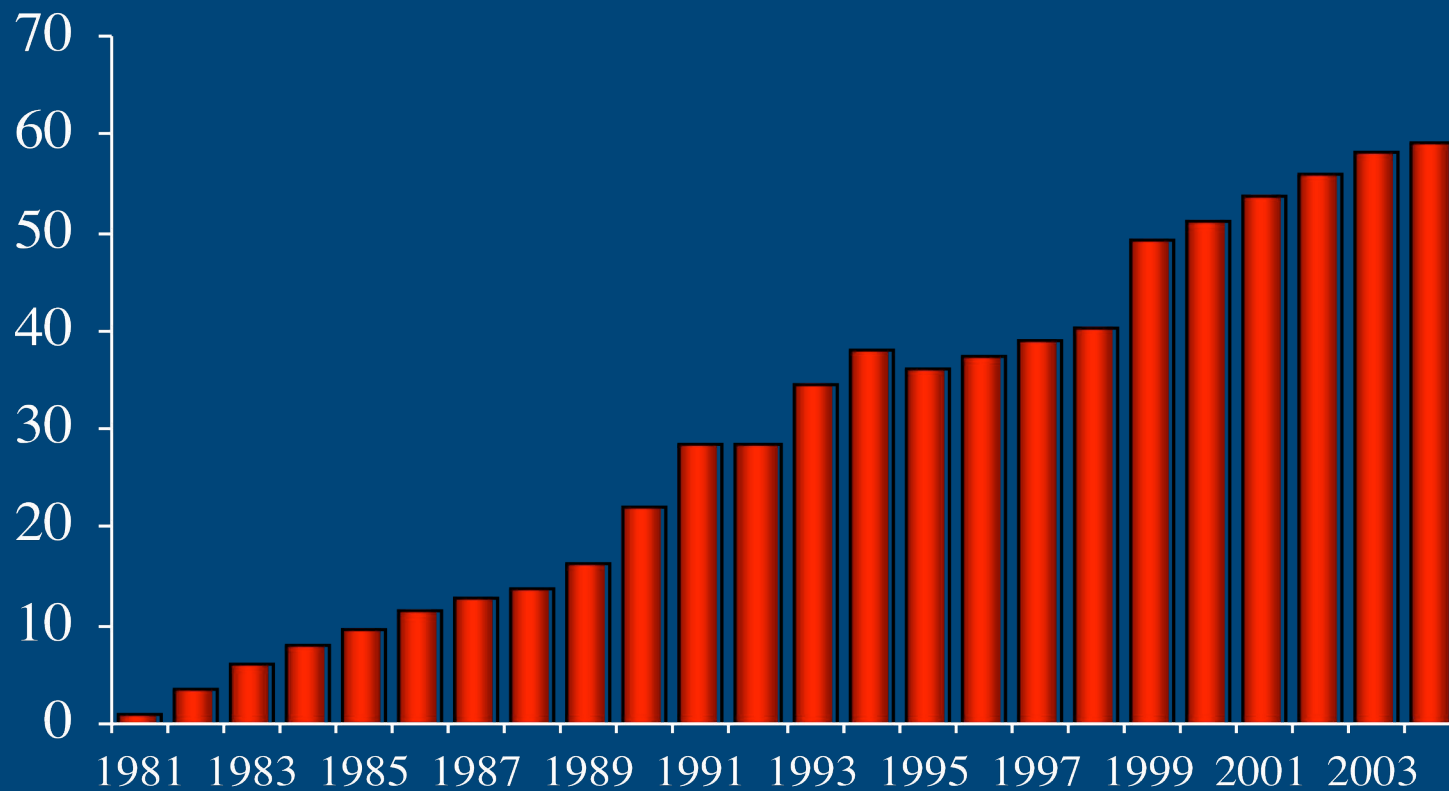


Source: Beck, Demirguc-Kunt and Levine (2005).

2. Chile in the New Global World



Chile's Pension Fund Assets (1981-2004, % of GDP)

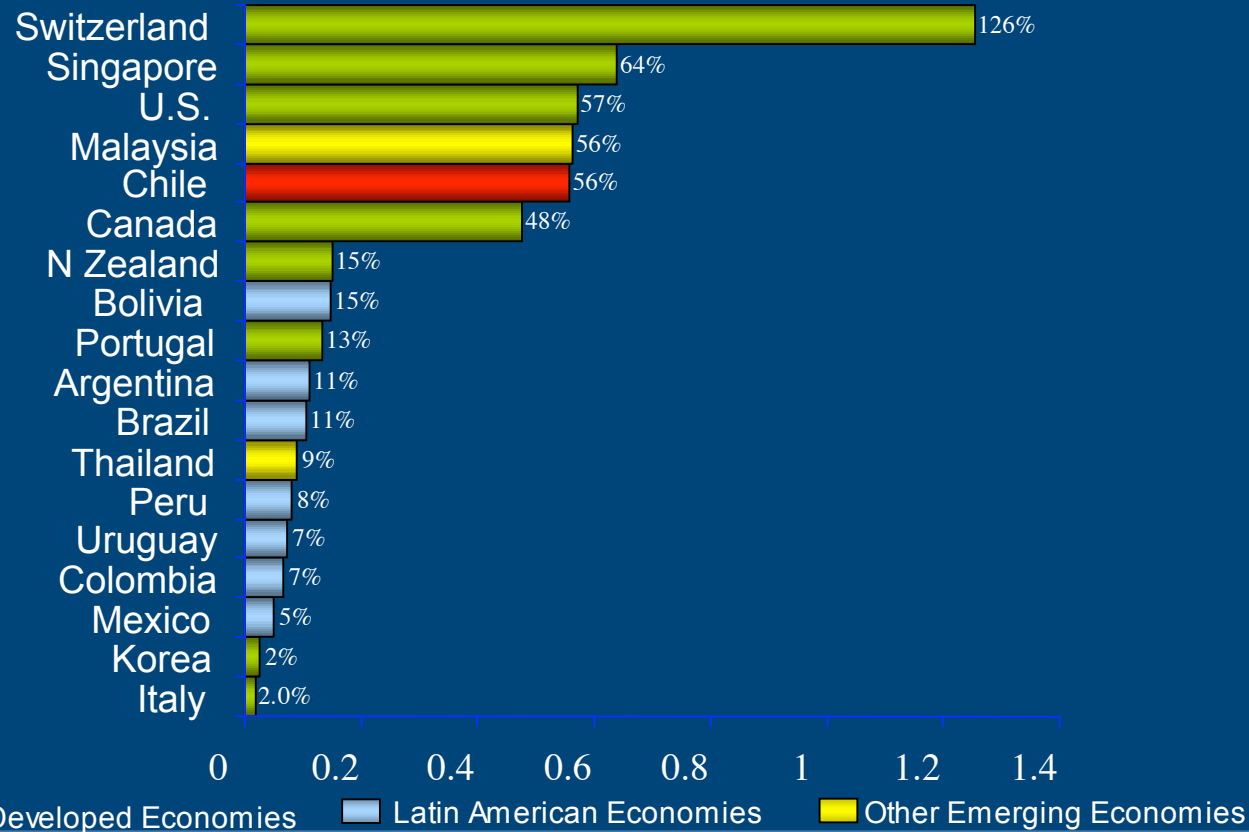


Source: Superintendence of AFPs.

2. Chile in the New Global World



Pension Fund Assets (As of 2002, %GDP)



Source: OECD (2003) and Davis and Hu (2005).

2. Chile in the New Global World

- This macroeconomic framework is internally consistent and robust to different scenarios.
 - ▲ It is oriented to reach price stability, but also permits the use of monetary policy to stabilize output in the short term.
 - ▲ Floating exchange rate facilitates the adjustment of the RER in the presence of external shocks.
- Macro stability has made Chile more resilient to shocks than it was two decades ago.

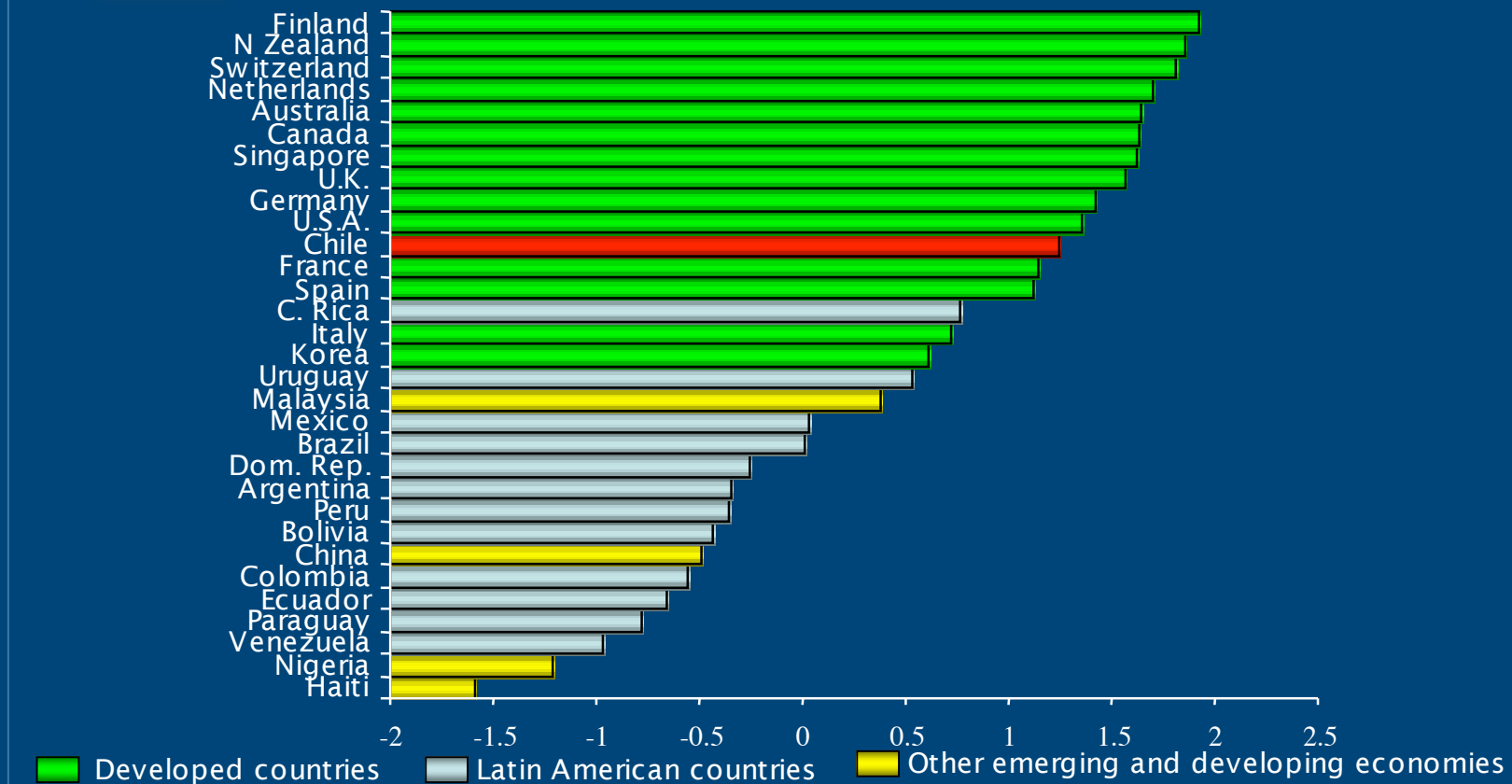
2. Chile in the New Global World

- Additionally, Chile has built institutions that give credibility and effectiveness to its policies:
 - ▲ Proper financial regulation and supervision;
 - ▲ Autonomous central bank;
 - ▲ Budgetary procedures;
 - ▲ Rule of law;
 - ▲ Well-defined and respected property rights.

2. Chile in the New Global World



Quality of Institutions (2005)



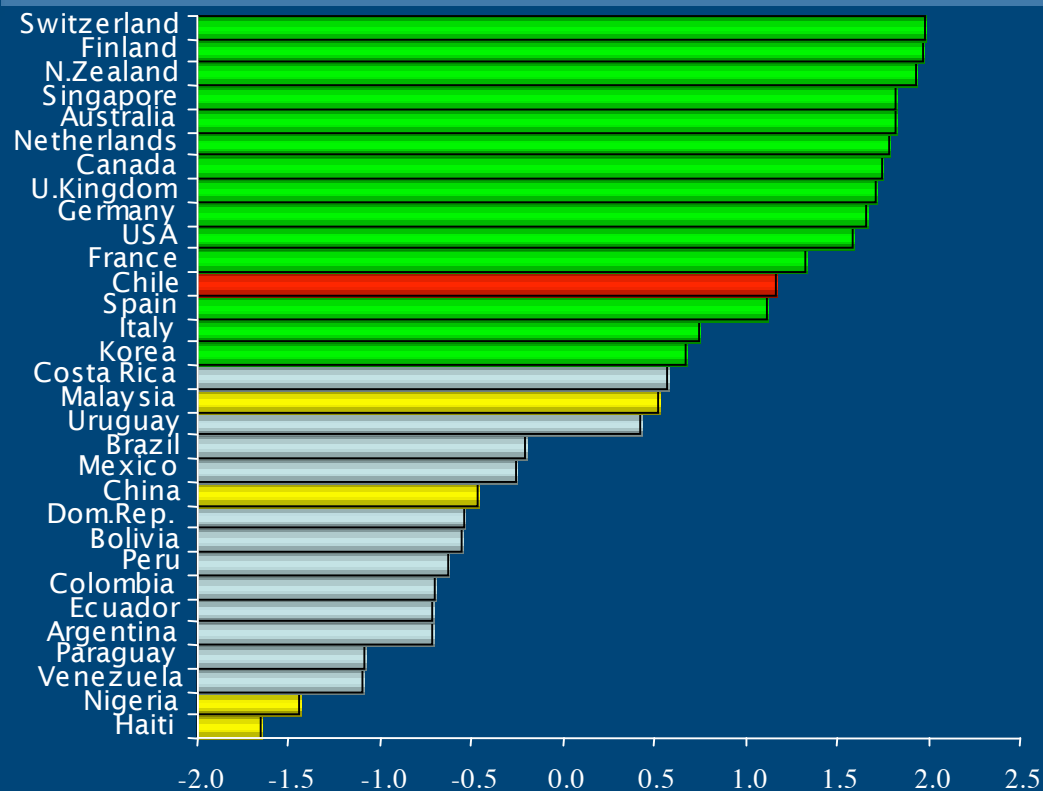
Source: World Bank (2005).

Note: Average of six indexes: rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability

2. Chile in the New Global World



Rule of Law (2004)



■ Developed countries ■ Latin American countries ■ Other emerging and developing economies

Source: World Bank (2005).

3. Outcomes of Chile's Integration into the World Economy

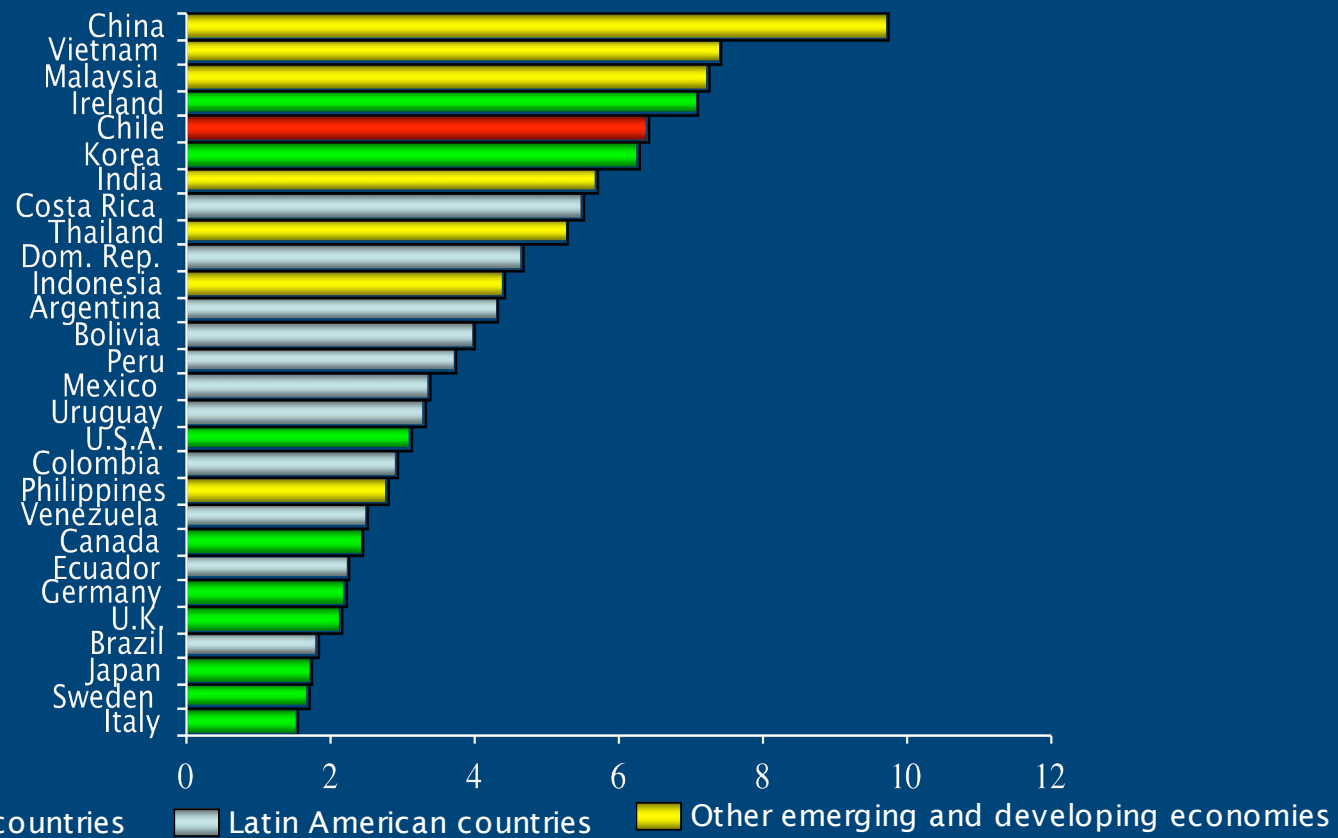
3. Outcomes of Chile's Integration

- Integration to the rest of the world, combined with good policies and institution building and strengthening, has allowed Chile to make great improvements in its macroeconomic and social indicators:
 - ▲ During the nineties, Chile was one of the fastest-growing economies in the world.
 - ▲ And this was to a large extent due to efficiency gains.

3. Outcomes of Chile's Integration



Economic Growth during the Nineties (selected countries, % per annum)

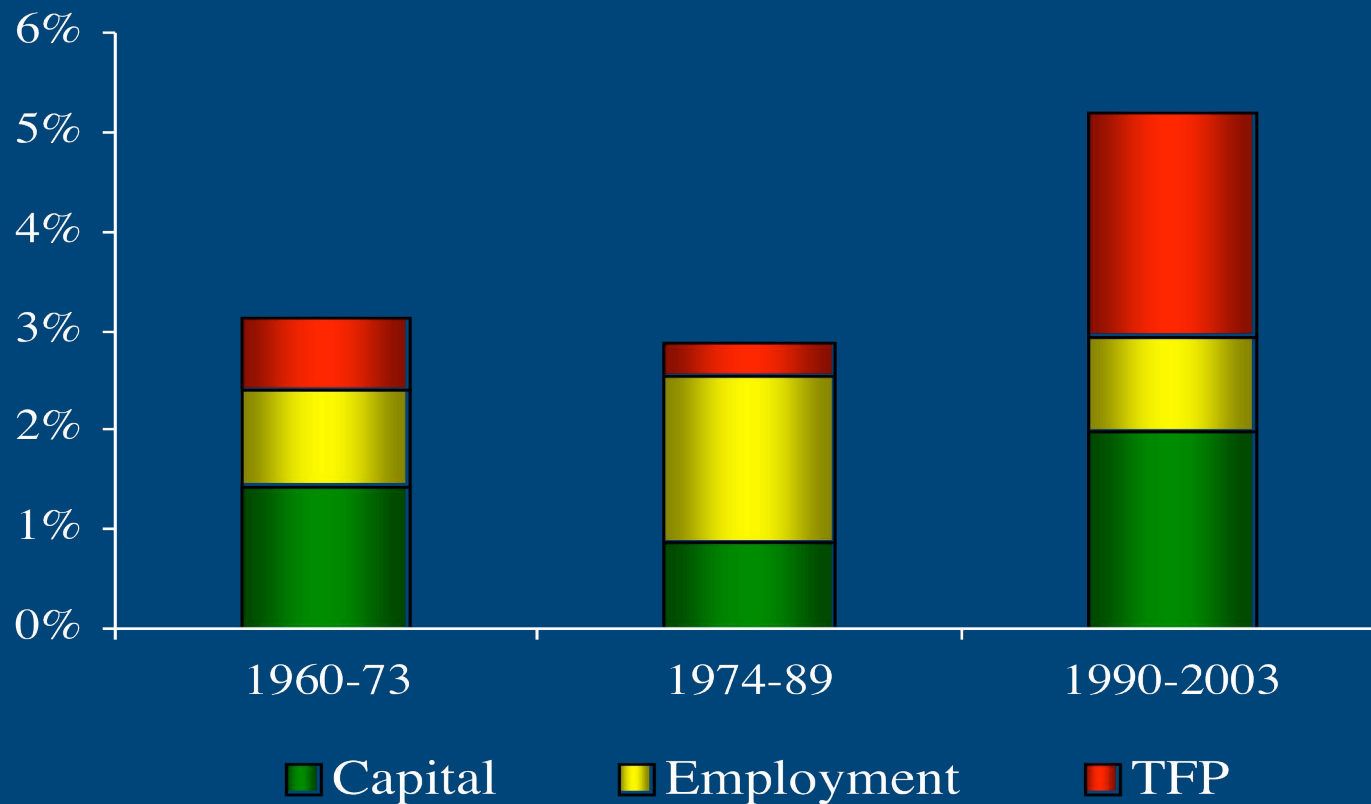


Source: IMF (2005).

3. Outcomes of Chile's Integration



Solow's Decomposition of Economic Growth *Chile: 1960-2003*



Source: Central Bank of Chile.

3. Outcomes of Chile's Integration

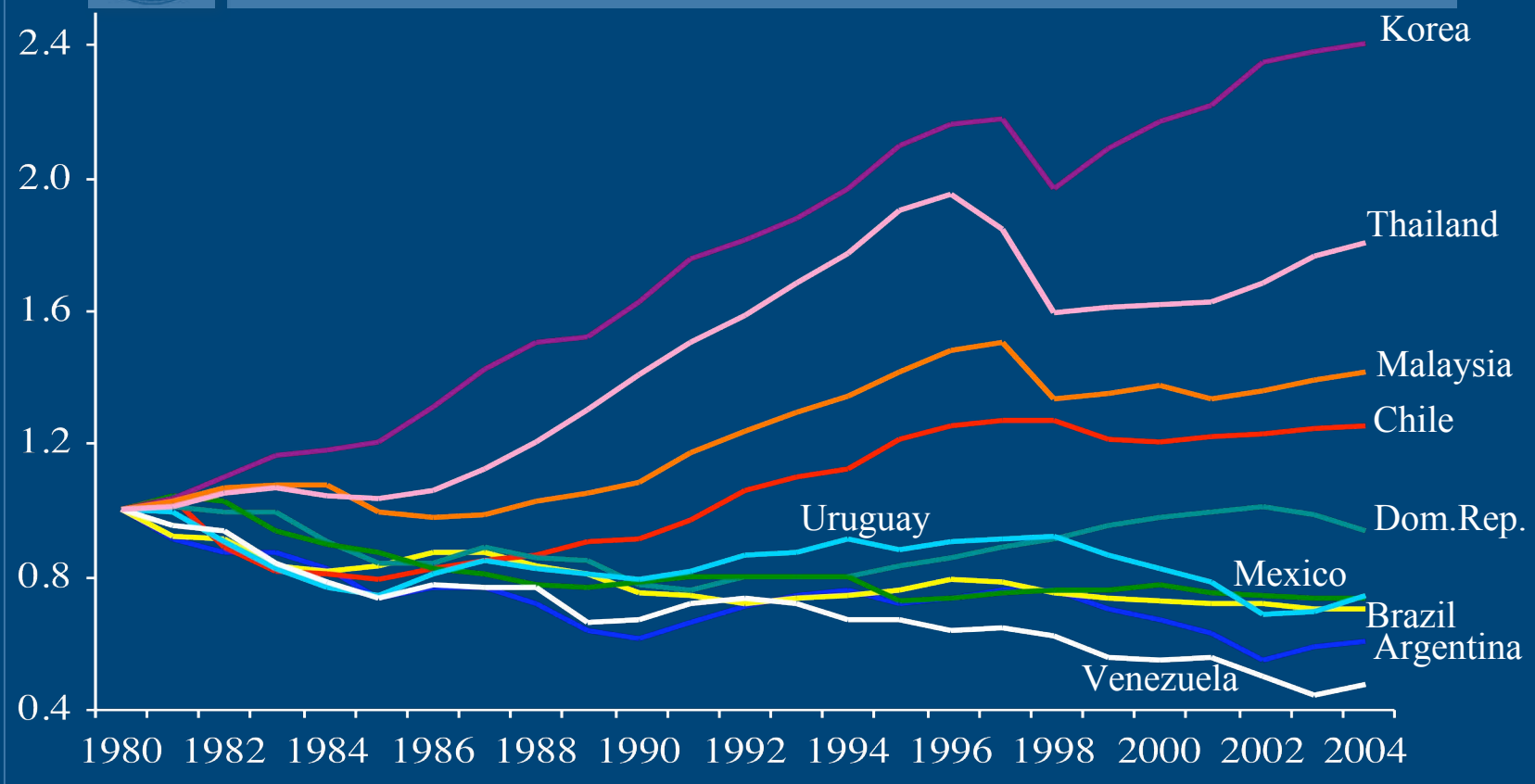
- Consequently, in the past 15 years:
 - ▲ Chile has shortened the per capita income gap with high-income countries by around 25%.
 - ▲ High growth and focalization of social expenditure have resulted in major advances in social indicators and poverty alleviation.
- Chile is today the most competitive economy in the region, comparable to countries like Spain, Portugal, New Zealand and Israel.

3. Outcomes of Chile's Integration



Relative Per Capita Output

(per capita GDP in country j over per capita GDP of G-7, PPP; 1980=1)

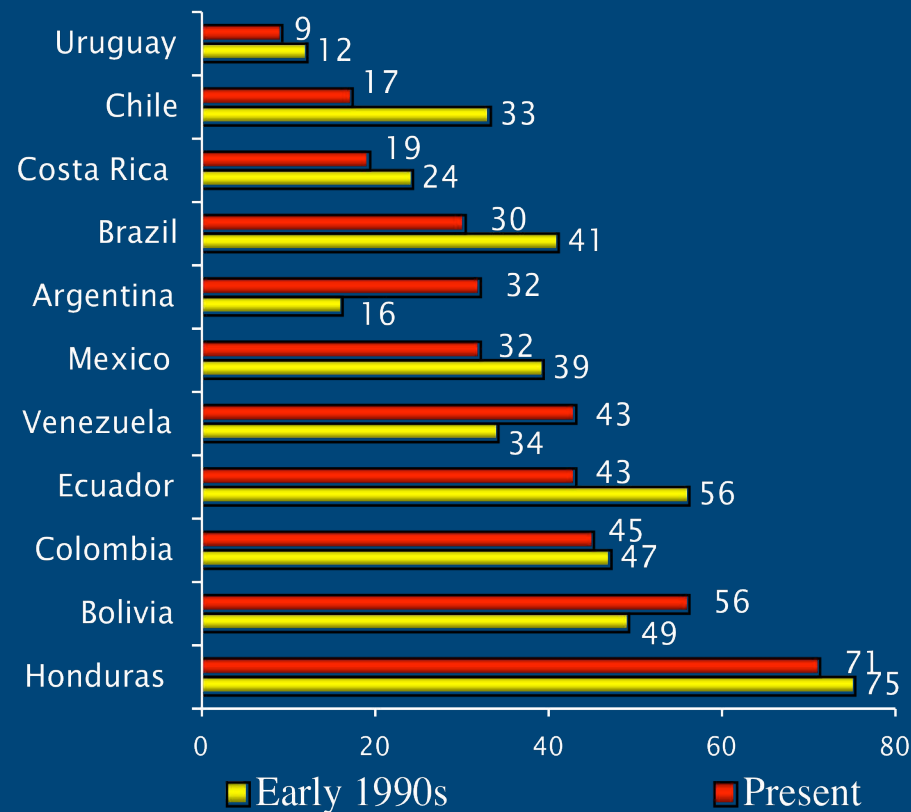


Source: Own calculations.

3. Outcomes of Chile's Integration



Poverty Rate (%)

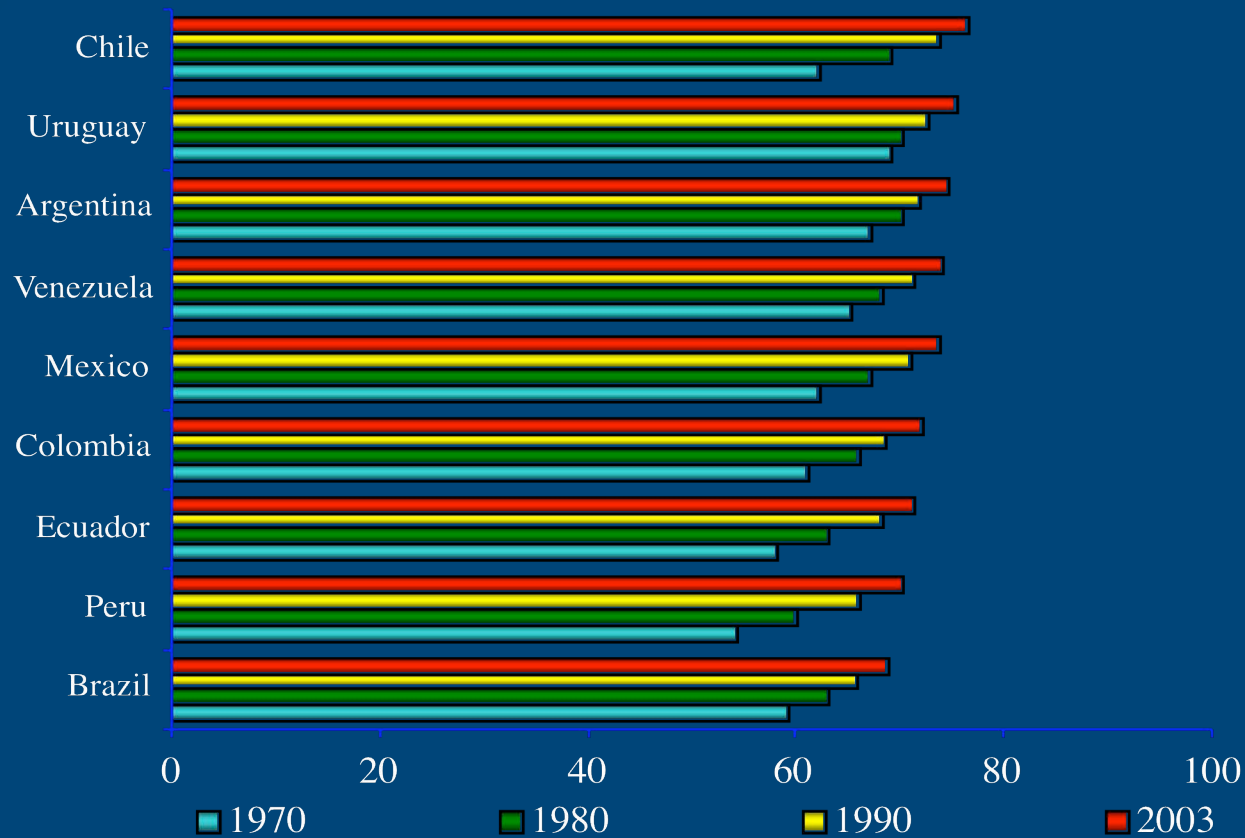


Note: Present stands for the years 2000, 2001 or 2002, depending of the country.
Source: ECLAC (2004).

3. Outcomes of Chile's Integration



Life Expectancy at Birth *(number of years)*

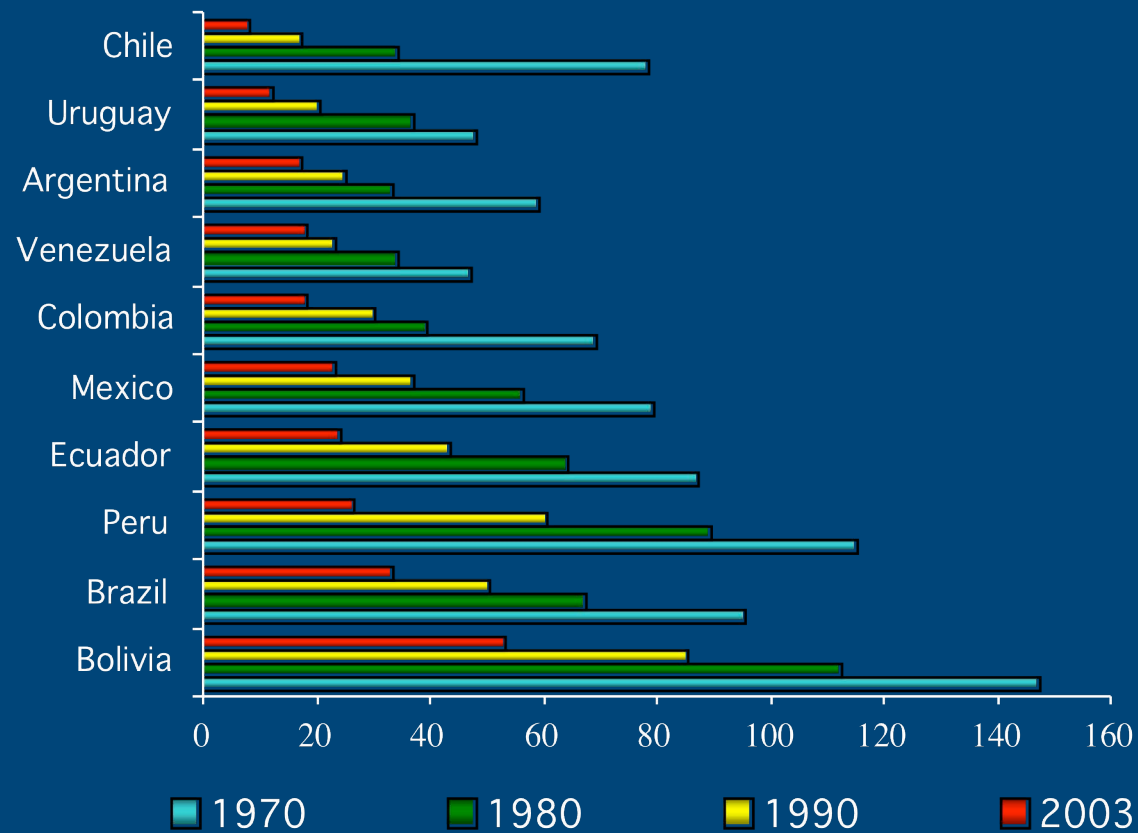


Source: World Bank, WDI 2005

3. Outcomes of Chile's Integration

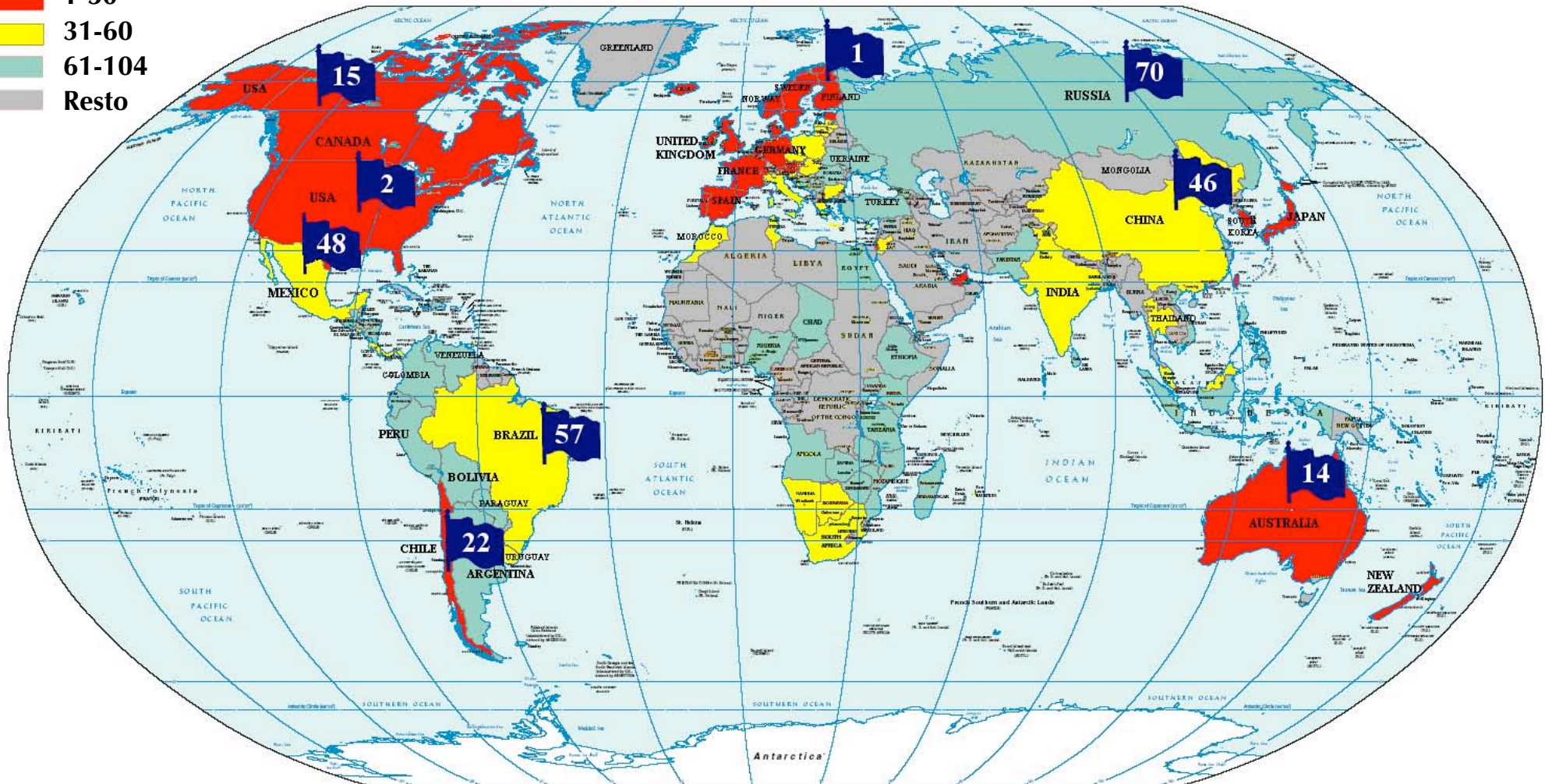


Infant Mortality (per 1000 born)



Source: World Bank, WDI 2005.

COMPETITIVENESS INDEX FOR GROWTH, 2004



Source: The Global Competitiveness Report 2004-2005, World Economic Forum

4. Challenges facing Chile in a Global World

4. Challenges facing Chile

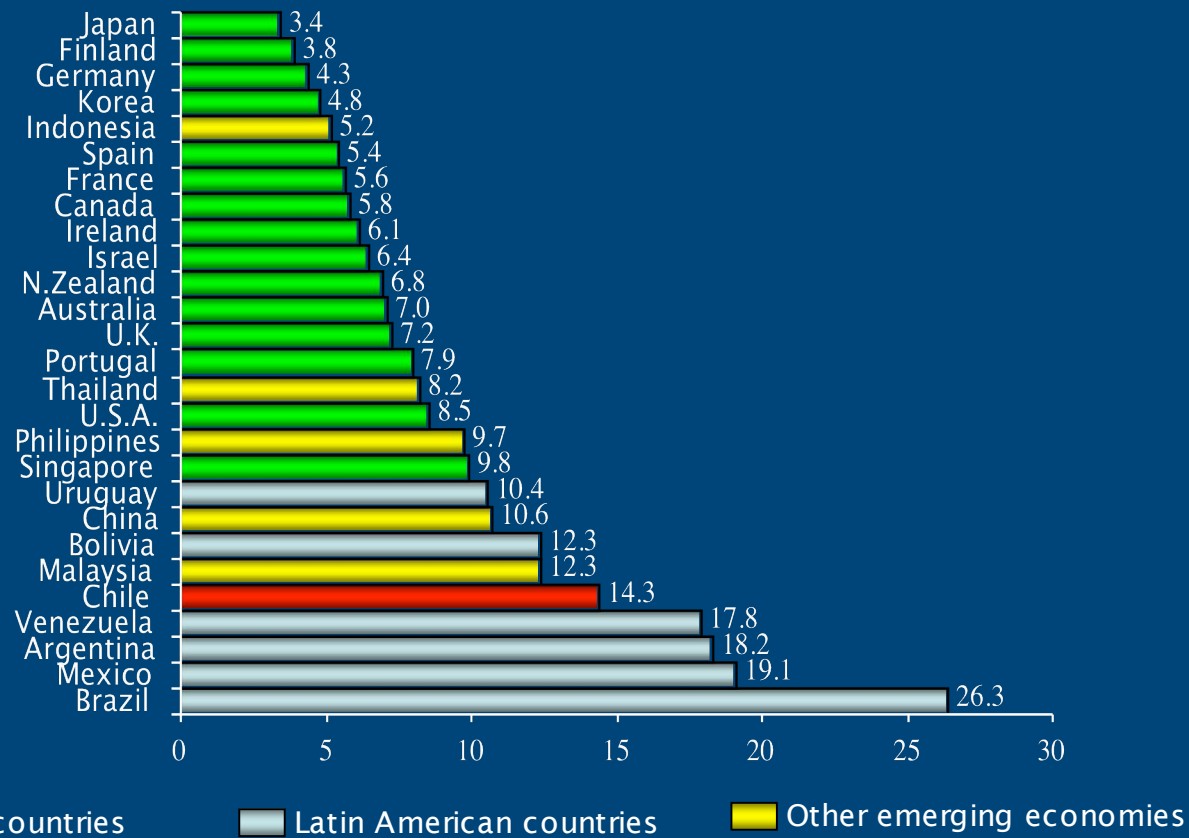
- Despite Chile's great progress, challenges remain in order to fully reap the benefits of globalization:
 - ▲ Take a new leap in productivity that permits us to generate a steady increase in the economy's growth rate.
 - Evidence shows that high, sustained growth has a direct effect on the welfare of the poorer groups.
 - ▲ Improve income distribution.

4. Challenges facing Chile



Income Distribution

(Ratio between 20% richest's income and 20% poorest's income)



Sources: WDI, World Bank (2005). In the case of Chile, the data is actualized using Casen 2003. When monetary and non monetary transferences, are considered the ratio in Chile falls to 7.6.

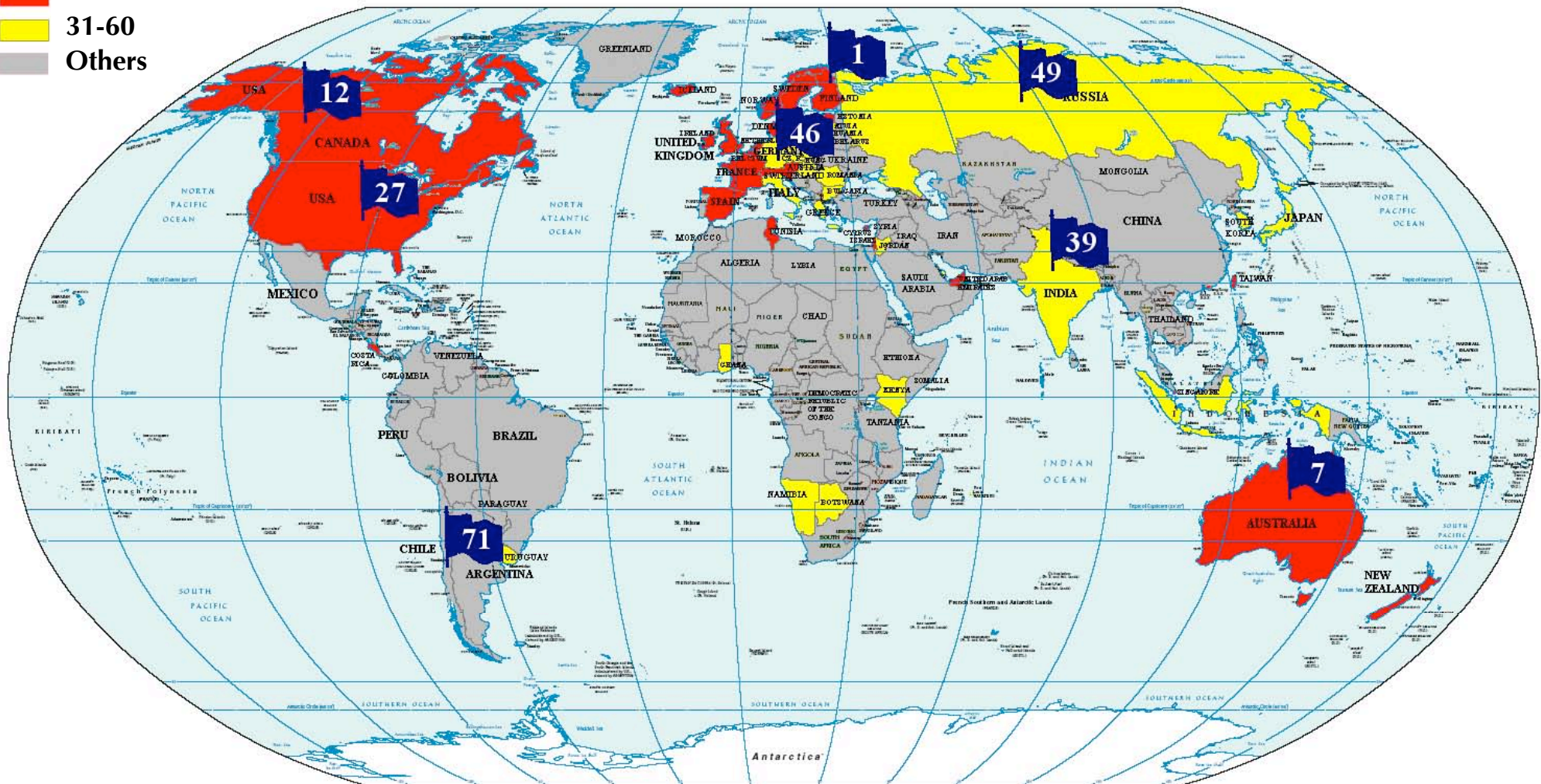
4. Challenges facing Chile

- Improving income distribution is a particularly important challenge for economies that are integrated to the global world.
 - ▲ Technological innovation is biased toward demanding highly skilled workers, so it calls for urgent medium-term policies to prevent a worsening of income distribution in the future.

4. Challenges facing Chile

- There is room for these challenges to be addressed effectively:
- In the medium term the main opportunities are:
 - ▲ Education:
 - Improve preschool and high school coverage;
 - Enhance quality of every educational level, with emphasis on preschool, elementary and high school for the two lower-income quintiles.
 - The main problem is poor management rather than a shortage of resources.
 - ▲ Health services:
 - Improve the efficiency in the use of resources.

QUALITY OF EDUCATIONAL SYSTEM, 2004

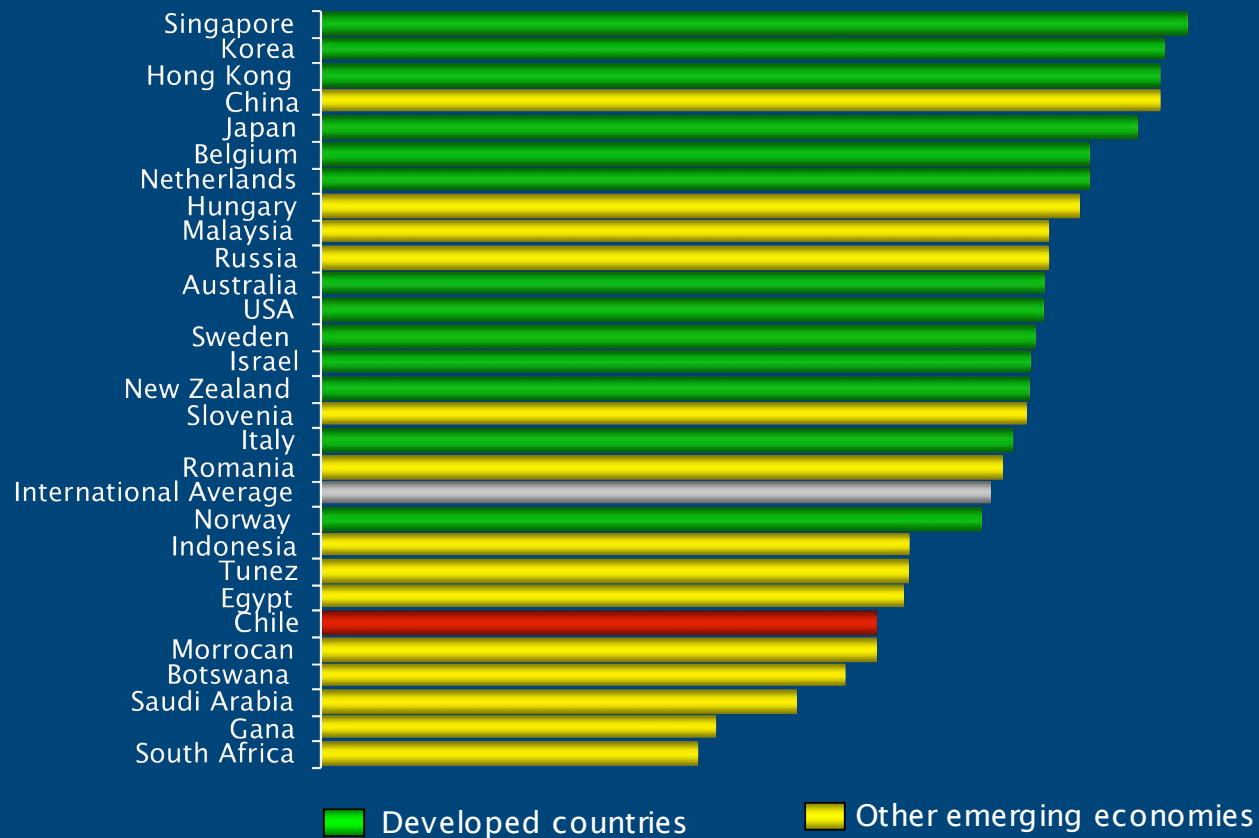


Source: The Global Competitiveness Report 2004-2005, World Economic Forum.

4. Challenges facing Chile



TIMSS Results in Mathematics (2003, eight graders)



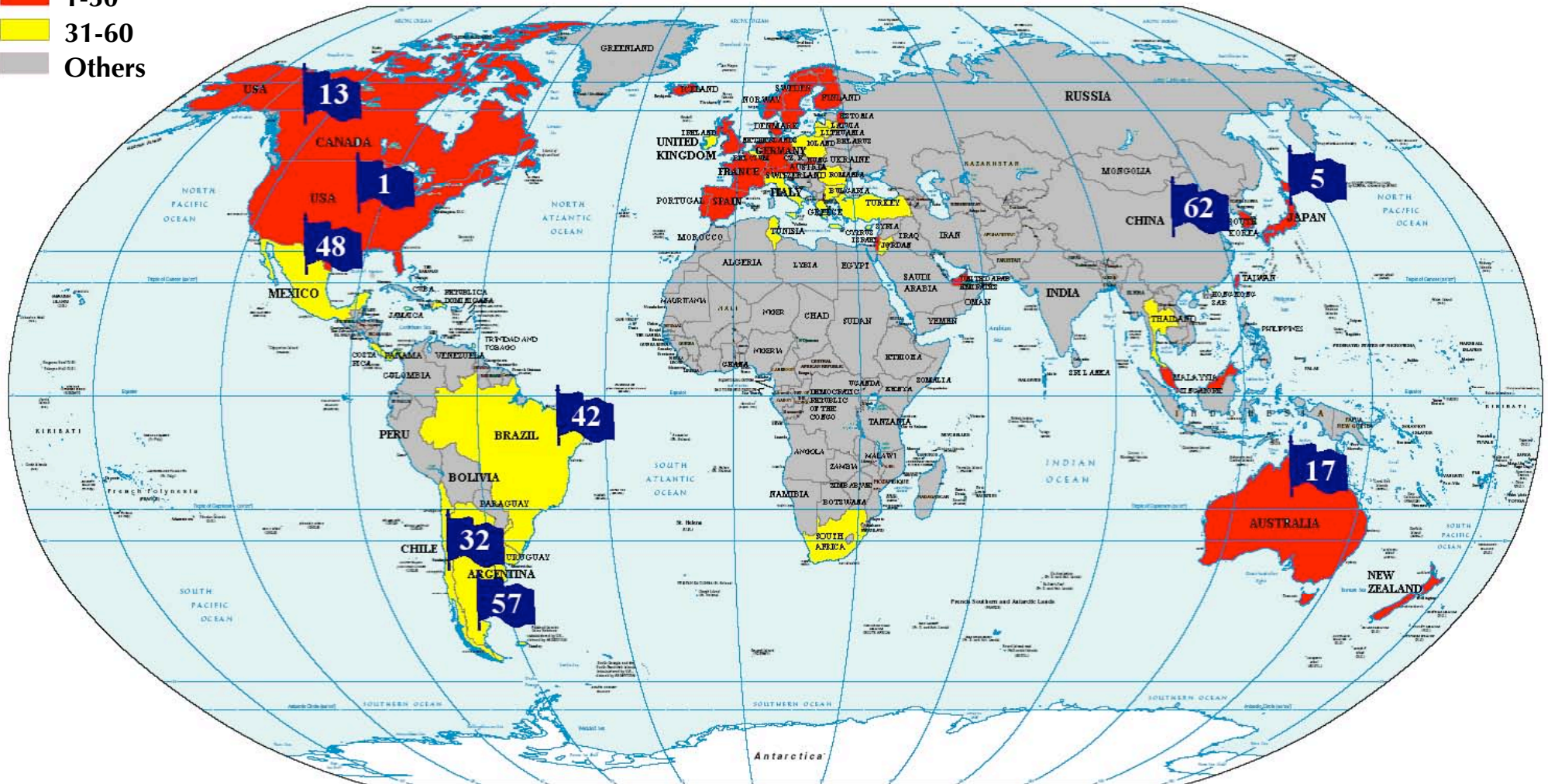
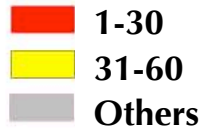
Source: International Study Center, Boston College.

4. Challenges facing Chile

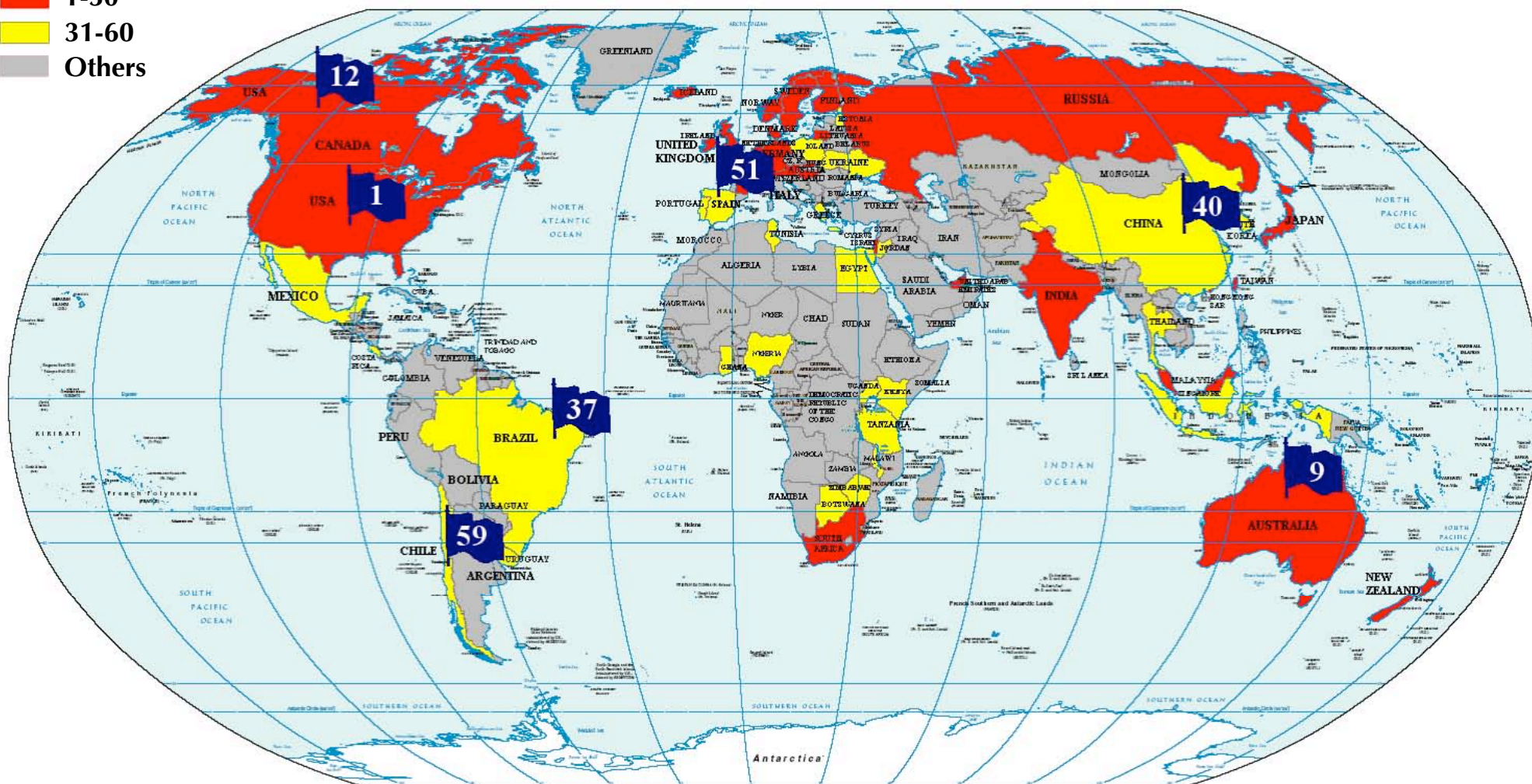
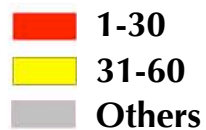
▲ Technological innovation:

- Change in policies and institutions to improve technological education and to increase the degree of technological adoption & innovation in the overall economy;
- Improve access to new technologies of micro, small and medium-sized enterprises;
- Promote greater interaction between universities, technological centers and enterprises.

TECHNOLOGY INDEX, 2004



QUALITY INDEX OF SCIENTIFIC RESEARCH INSTITUTIONS, 2004



Source: The Global Competitiveness Report 2004-2005, World Economic Forum

5. Conclusions

5. Conclusions

- The new trends in the world economy create great opportunities for countries.
- To embrace them, policies and institutions must be adjusted.
- In the past 30 years, Chile has made big progress toward building and strengthening its institutions and reforming its policies.
- Thus, it has benefited from the increasing globalization.
- The strength of our economy permits us to plan ahead to the medium to long term.

5. Conclusions

- To narrow the still large gap separating us from developed countries and improve income distribution, the country must double its efforts in the weaker areas (education).
- However, in the pursuit of these objectives, special care must be given to the stability of policies and institutions that support the strengths that the country has built.
- This is a precondition to succeed in addressing the challenges of the future.



The New Global World: Challenges and Opportunities for a Small Open Economy

JULY 1st, 2005

Vittorio Corbo
Governor