



Chilean Reform Experience

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Outline

1. Introduction
2. Chile's reform process and institutional buildup
3. Performance of the Chilean economy
4. Lessons from the Chilean reform experience
5. Conclusions

1. Introduction



Introduction

- Broad consensus about the importance of reaching high and sustainable economic growth:
 - ▲ Countries that grow faster and, more importantly, on a sustainable basis, can reduce poverty and improve the standard of living of their population sooner than those that don't.
- An economy can achieve growth through “*transpiration*” (factor accumulation) and “*inspiration*” (raising total factor productivity), but only the latter provides the basis for high and sustainable growth.

Introduction

- Key elements for sustainable growth are:
 - ▲ Macroeconomic stability;
 - ▲ Competitive open market economy;
 - ▲ Financial development;
 - ▲ Institutional coverage and quality;
 - ▲ Comprehensive social network.
- Technological innovation and education of the labor force are also important elements in the development process.
- Lack of the above elements can constraint growth and cause economic crises, reverting the development process and affecting specially the poorest group.

Introduction

- Chile and China represent cases of high growth, with outstanding performances during the last twenty years.
- Both countries have achieved this successful performances thanks to important reform processes.
- The Chilean experience has some unique elements that can be used to derive policy implications for other emerging and developing countries.

2. Chile's economic reforms and institutional buildup



Chile's economic reforms and institutional buildup

- In the sixties, the Chilean economy was closed to international trade, suffered from widespread price controls, a high degree of state intervention and severe macroeconomic imbalances:
 - ▲ Fiscal deficit around 30% of GDP;
 - ▲ Annual inflation rate above 500%;
 - ▲ Average import tariff of 105% (with great dispersion), multiple exchange rates and many other restrictions to international trade (e.g., quotas);
 - ▲ Price and interest-rate controls.

Chile's economic reforms and institutional buildup

- In the seventies, Chile initiated its economic transformation that continues to this day.
- First-generation reforms included:
 - ▲ Fiscal adjustment: VAT was introduced in 1975 and fiscal surplus reached in 1976;
 - ▲ Trade reform: non-tariff barriers were lifted and tariffs cut unilaterally to 10% flat in 1979;
 - ▲ State-owned enterprises and banks were privatized or returned to previous owners.

Chile's economic reforms and institutional buildup

- Furthermore:
 - ▲ Previously controlled prices and interest rates were liberalized;
 - ▲ Capital account restrictions were partly lifted while exchange rates were unified;
 - ▲ Restrictions to banks and other intermediaries began to be lifted.
- In 1981, Chile carried out a major reform to the social security system.

Chile's economic reforms and institutional buildup

- Stabilizing, and market oriented policies have allowed quick growth. However, some weaknesses have developed.
- The fixed exchange rate combined with weak regulatory and supervisory frameworks of the banking system exacerbated moral hazard and fragility in the banking industry.
- The sharp external shock (i.e. the increase in world interest rates and the dollar appreciation of the early 1980s) was all it took to develop a deep macroeconomic and financial crisis.

Chile's economic reforms and institutional buildup

- The 1982-83 crisis uncovered major regulatory shortcomings and triggered in 1986 a revision of several institutions (second-generation reforms), in particular:
 - ▲ New banking and bankruptcy laws;
 - ▲ The Central Bank being granted full autonomy and precluded by law from financing the government (1989).
- In 1989, a successful transition to democracy began, maintaining and strengthening the already prosperous market economy model.
- Since then, additional weight has been given to social policies as a way to build social cohesion and alleviate poverty.

Chile's economic reforms and institutional buildup

- The reform process in the nineties included:
 - ▲ Competition in telecommunications (multi-carrier system, 1994);
 - ▲ Private sector involvement in infrastructure development through BOT concessions (1991-92);
 - ▲ Deeper integration into the world economy through unilateral tariff reductions (1991 and 1998) and FTAs with important countries (since 1996);
 - ▲ Anti-trust rules (1994);
 - ▲ Upgrading of banking regulation (1997);
 - ▲ Adoption of inflation targeting regime (1991-99);
 - ▲ Abolition of the exchange rate band (1999).

Chile's economic reforms and institutional buildup

- In this decade, Chile has continued strengthening its macroeconomic and institutional framework:
 - ▲ Adopted a fiscal rule (2001), of a structural fiscal surplus equivalent to 1% of GDP;
 - ▲ Eliminated all capital controls, completing the opening of the capital account (2001);
 - ▲ Reformed the capital markets (2001);
 - ▲ Signed free trade agreements with major trade partners: Canada (1996), Mexico (1998), Central America (1999), European Union (2002), EFTA (2003), United States (2003), South Korea (2003), China (2005) and P4 (2005);
 - ▲ Created the Competition Tribunals (2003).

3. Performance of the Chilean economy

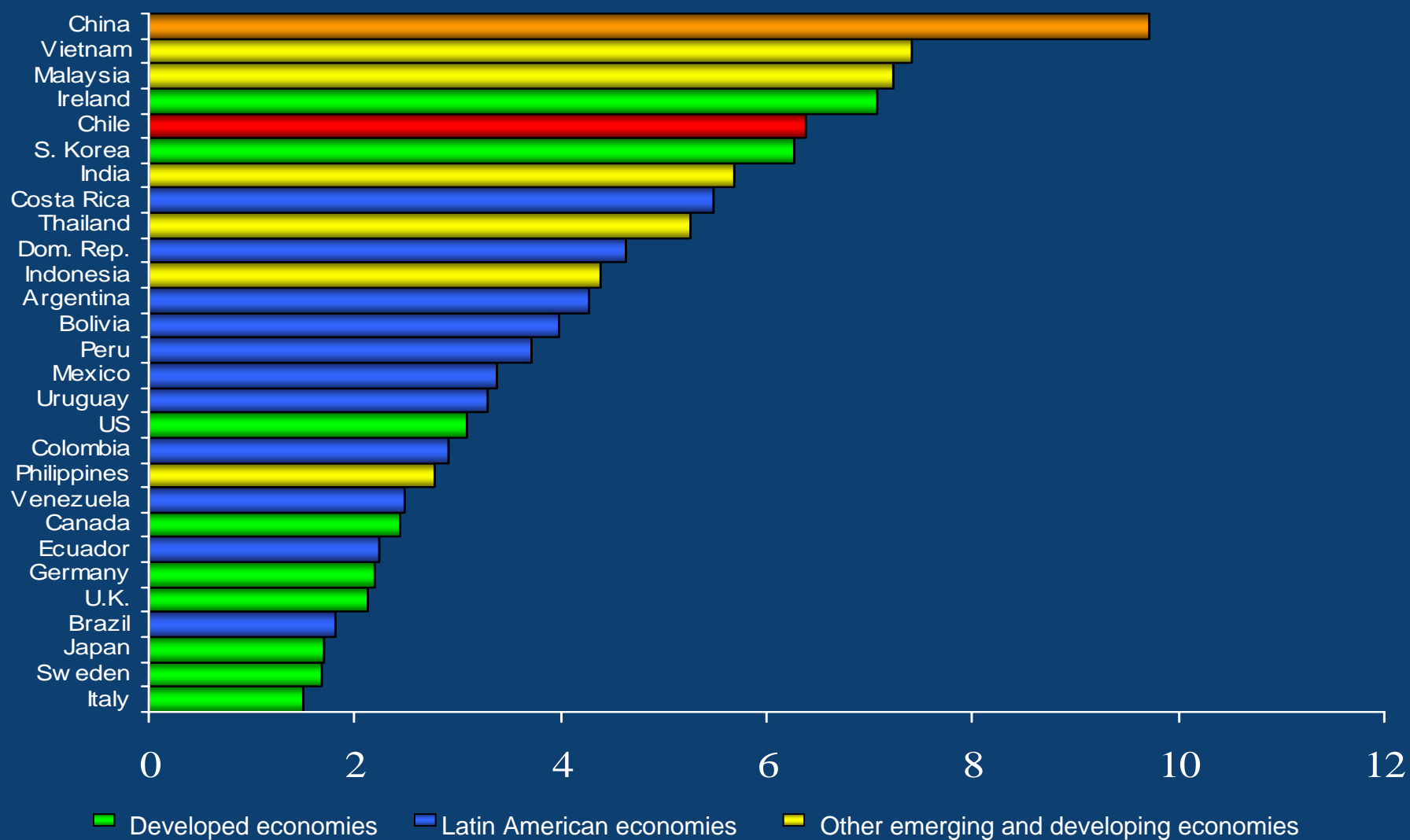


Performance of the Chilean economy

- With the reforms, Chile acquired solid macro fundamentals together with modern and robust institutions, all necessary elements for attaining high and sustainable growth rates:
 - ▲ During the 1990s, Chile was one of the fastest-growing economies in the world.
 - Largely due to efficiency gains.
 - ▲ Closing its per capita income gap with developed countries by 30% in twenty years.
 - Sharp contrast with the experience of other countries in Latin America, however still modest when compared to Asian developing countries.
- Gradual decline in inflation approaching industrial countries' levels.

Economic Growth during the Nineties

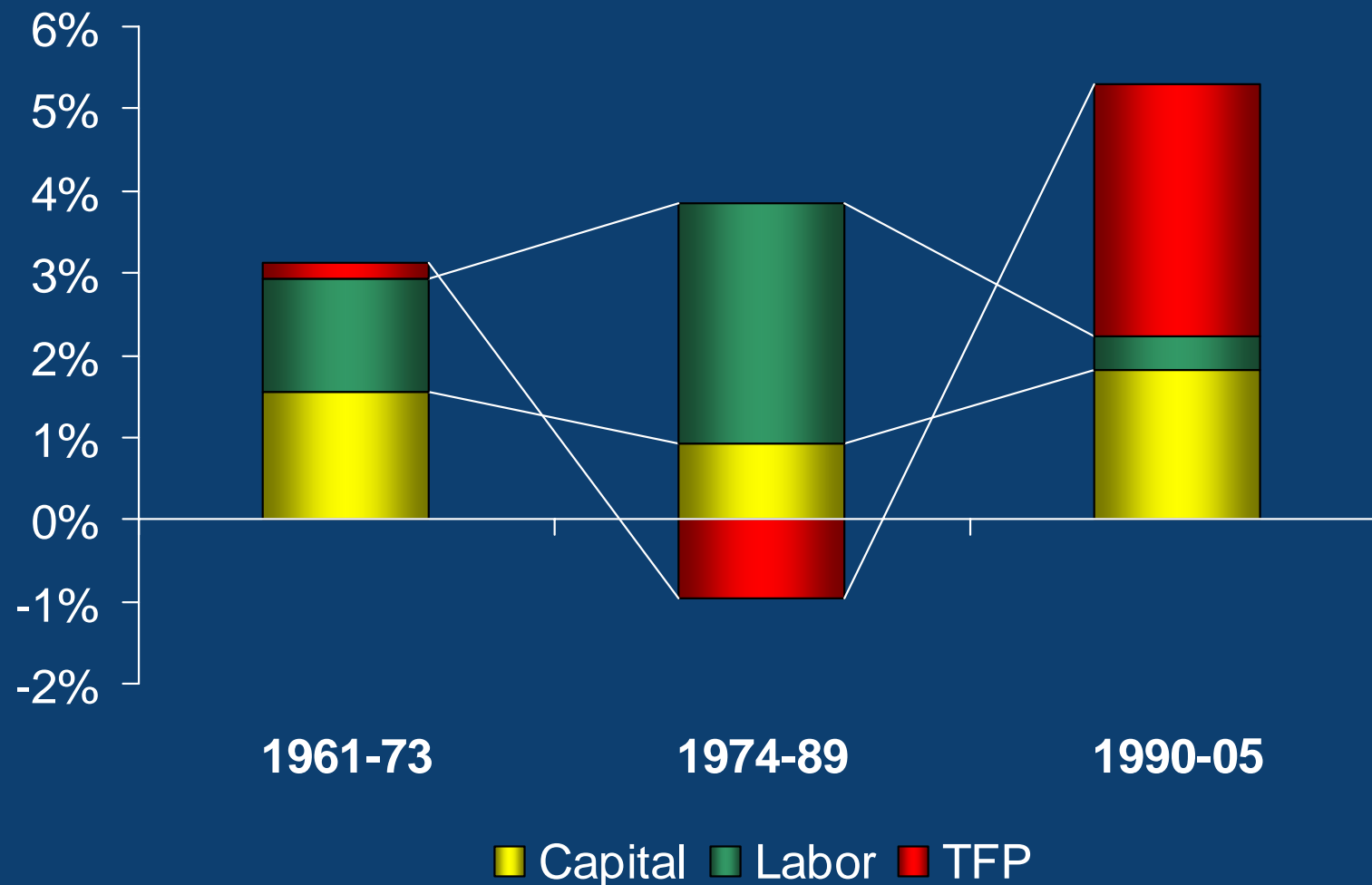
(% per annum)



Source: IMF (2005).

Solow's Decomposition of Economic Growth

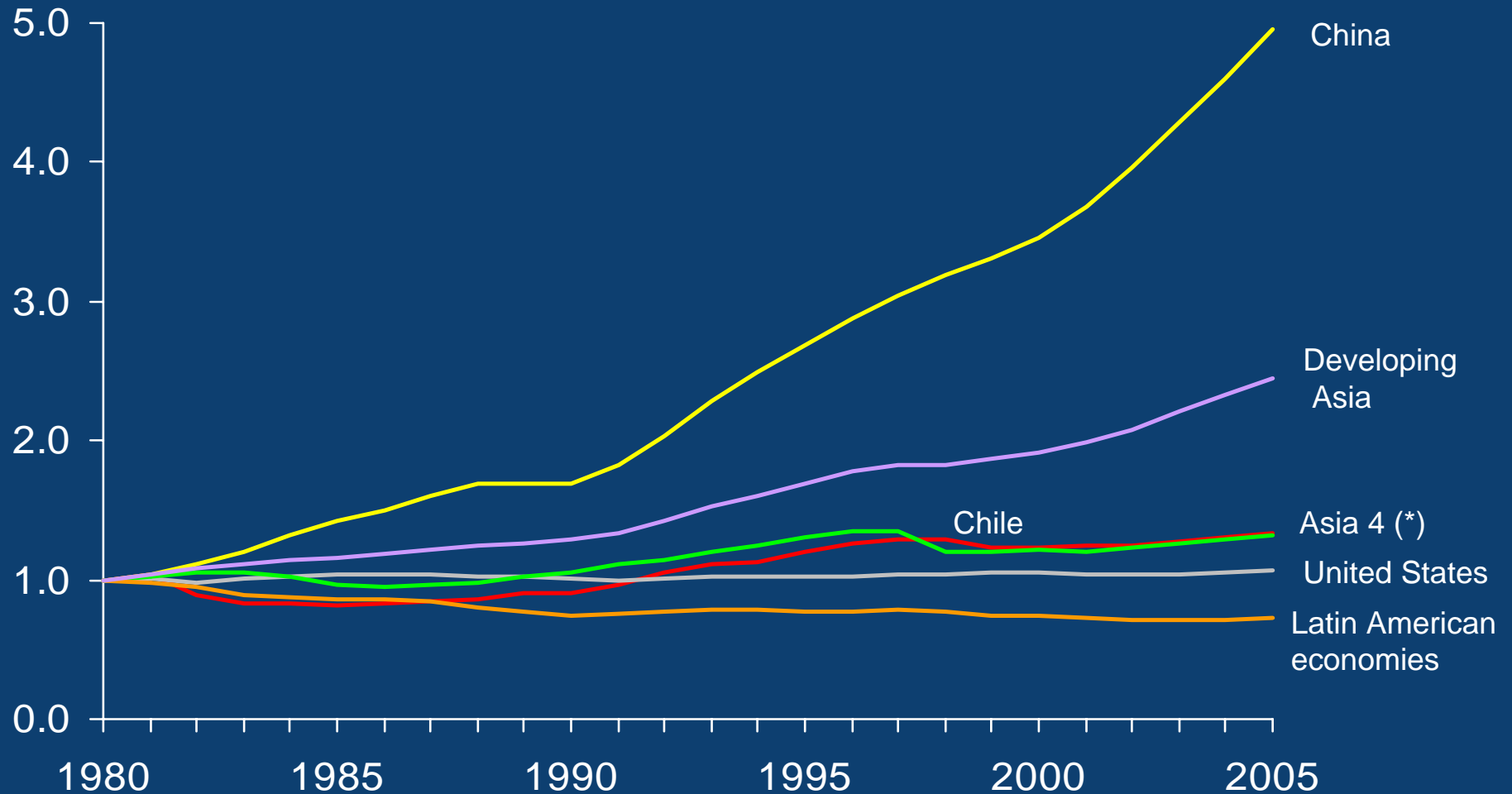
(Chile: 1960-2005)



Source: Fuentes, Larraín and Schmidt Hebbel (2004).

Relative Per Capita Output

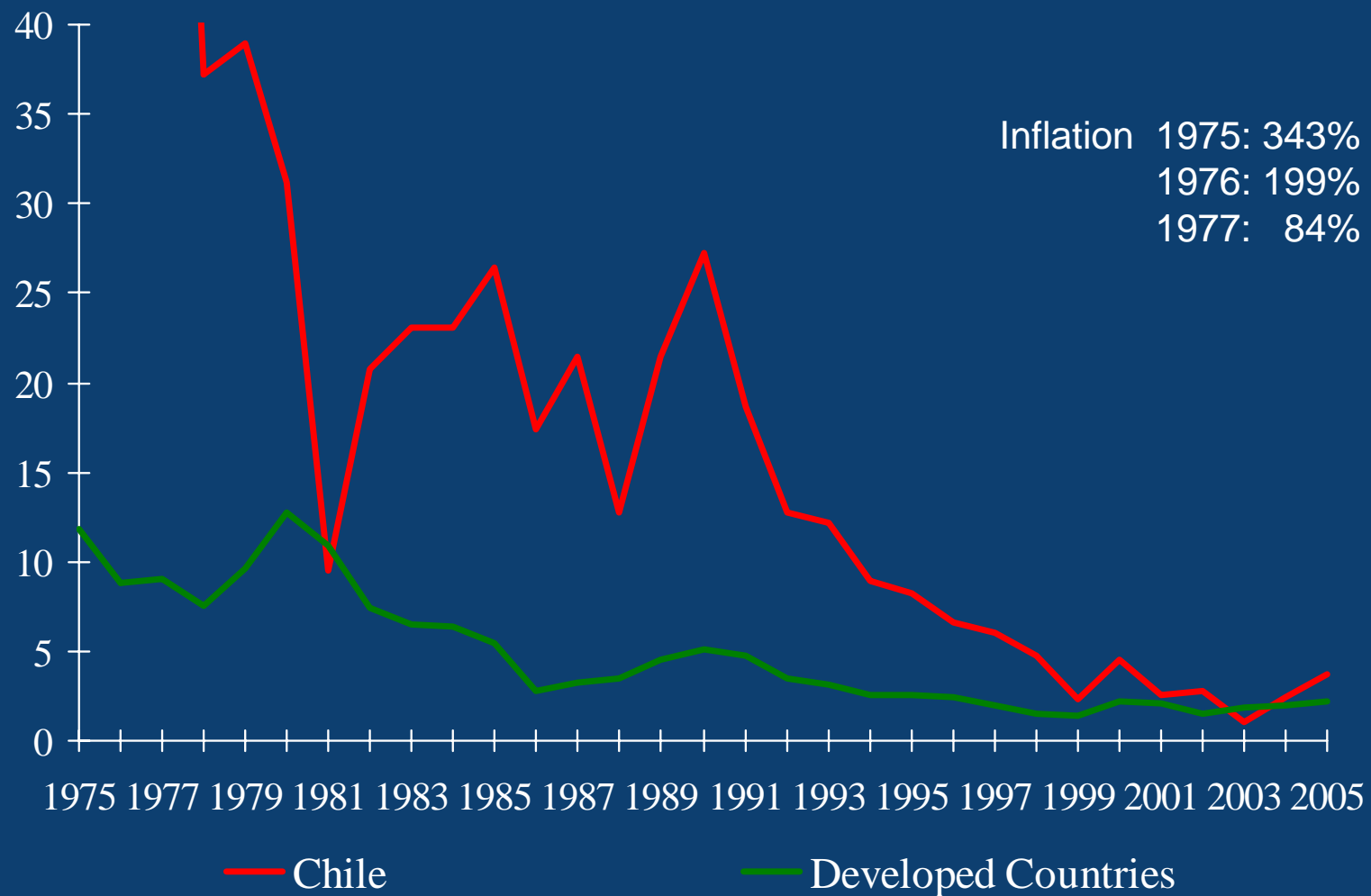
(per capita GDP in country *j* over per capita GDP of G-7, PPP; 1980=1)



(*) Asian 4: Malaysia, Indonesia, Thailand and Philippines.
Source: Own calculations.

Inflation Rate

(%)



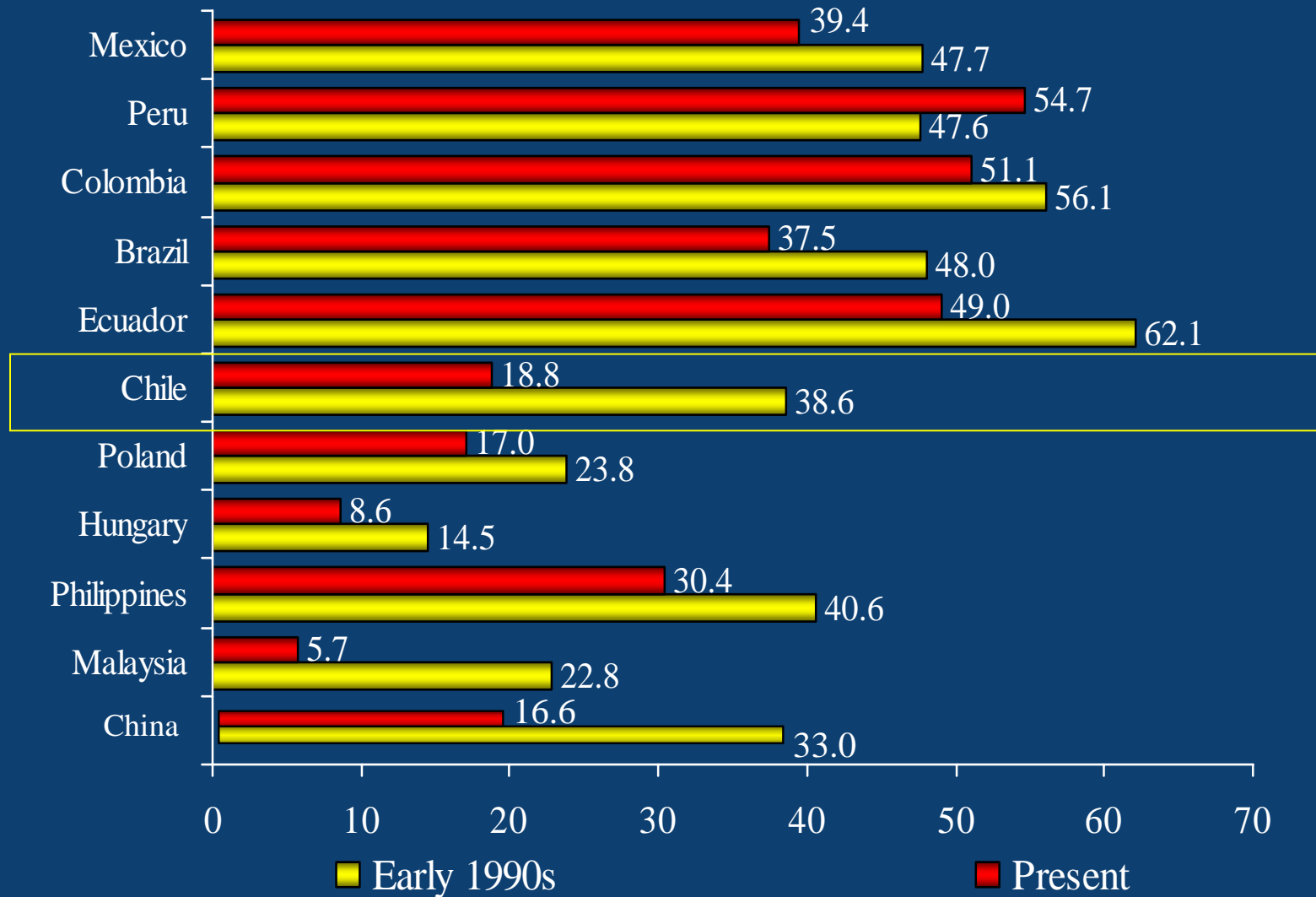
Source: Central Bank of Chile.

Performance of the Chilean economy

- The fast expansion of this period allowed Chile to improve social indicators substantially:
 - ▲ Incidence of poverty was cut in half in fifteen years;
 - ▲ Mortality rate and life expectancy have also improved sharply.
- As a consequence, Chile is today one of the most competitive emerging market economies.
- Country risk is among the lowest in emerging market economies.

Poverty Rate

(%)

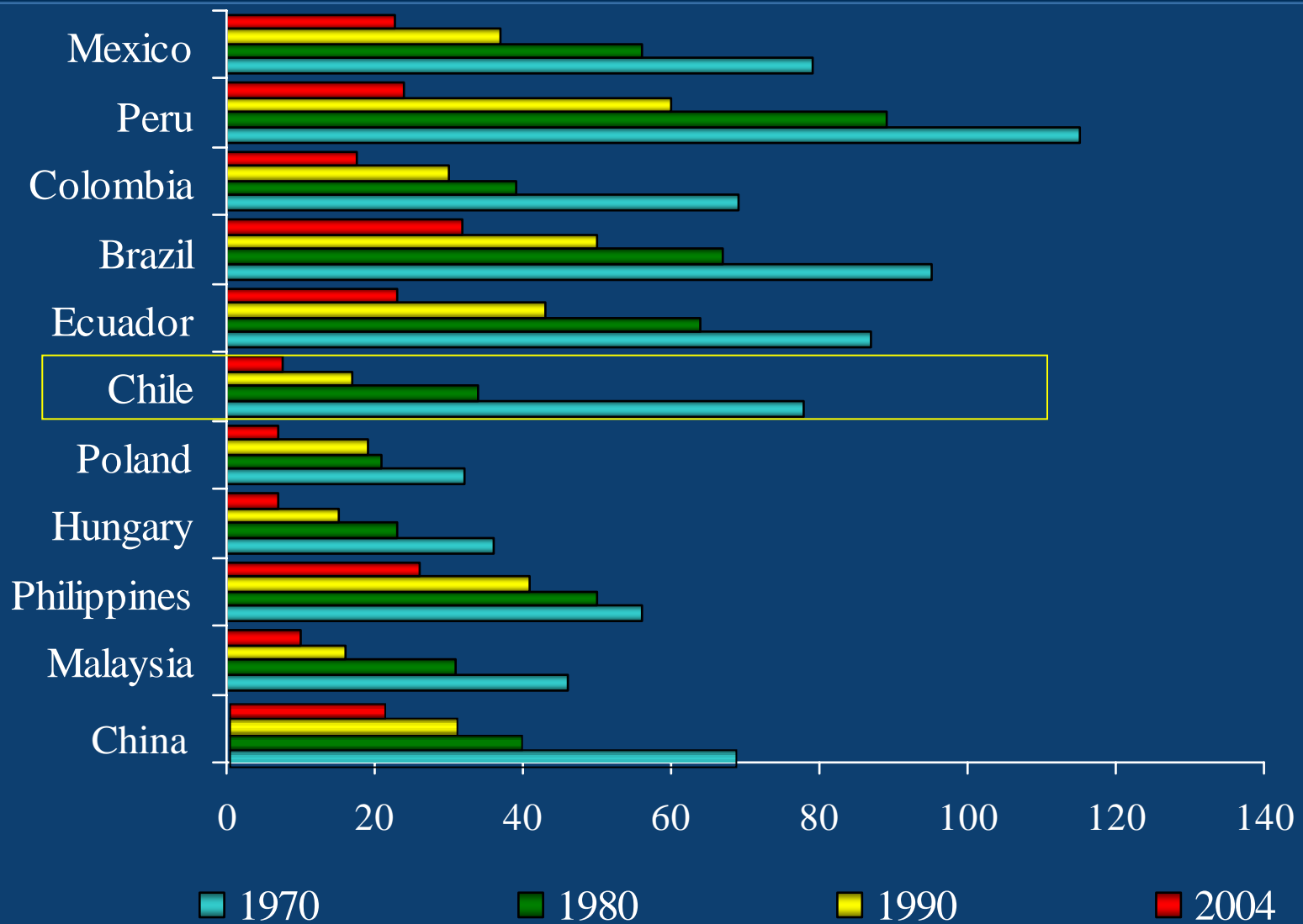


Note: Present stands for the years 2002 or 2003, depending on the country.

Sources: ECLAC (2004), MIDEPLAN (2005), Asia Development Bank and World Bank.

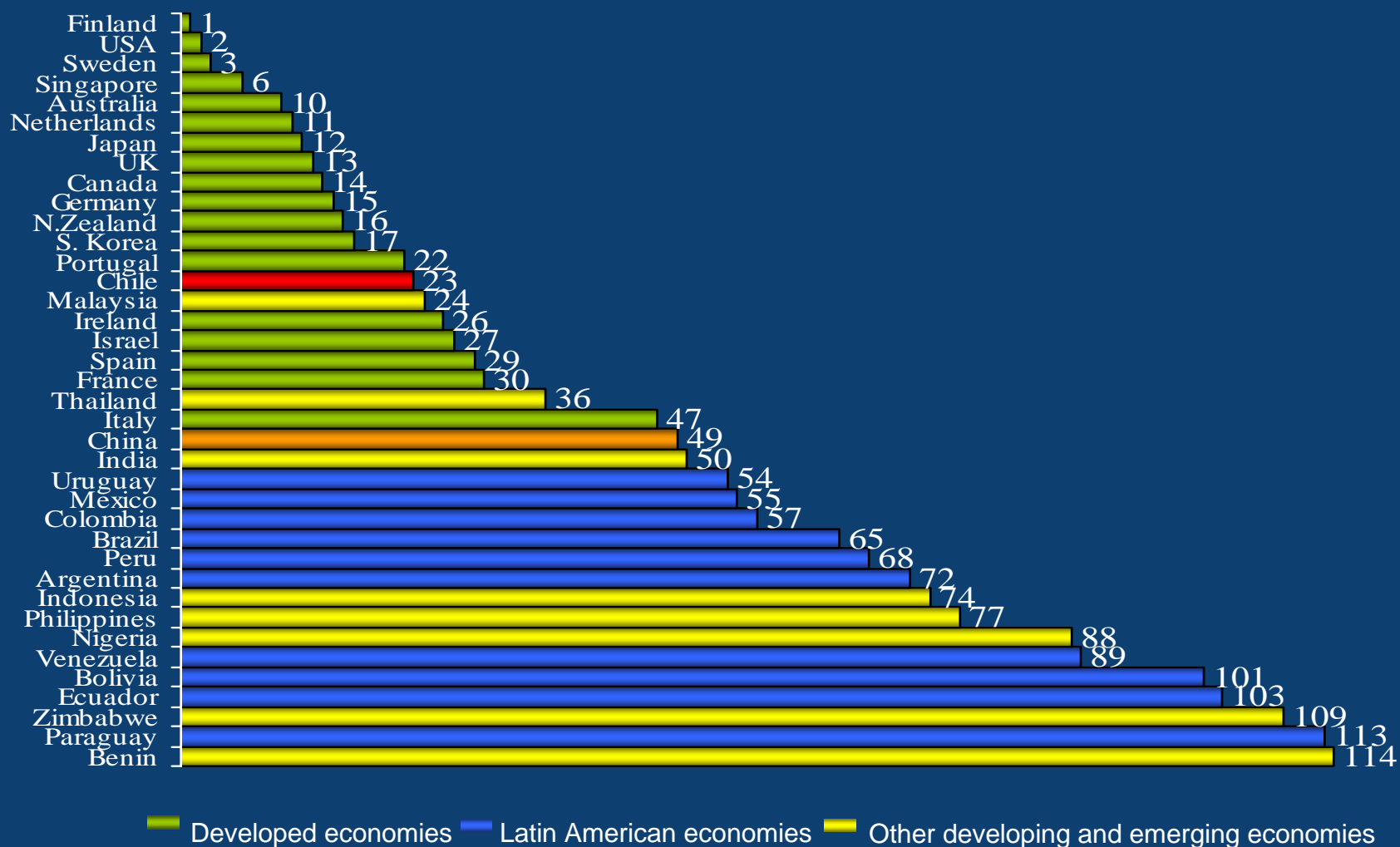
Infant Mortality

(per 1000 born)



Competitiveness

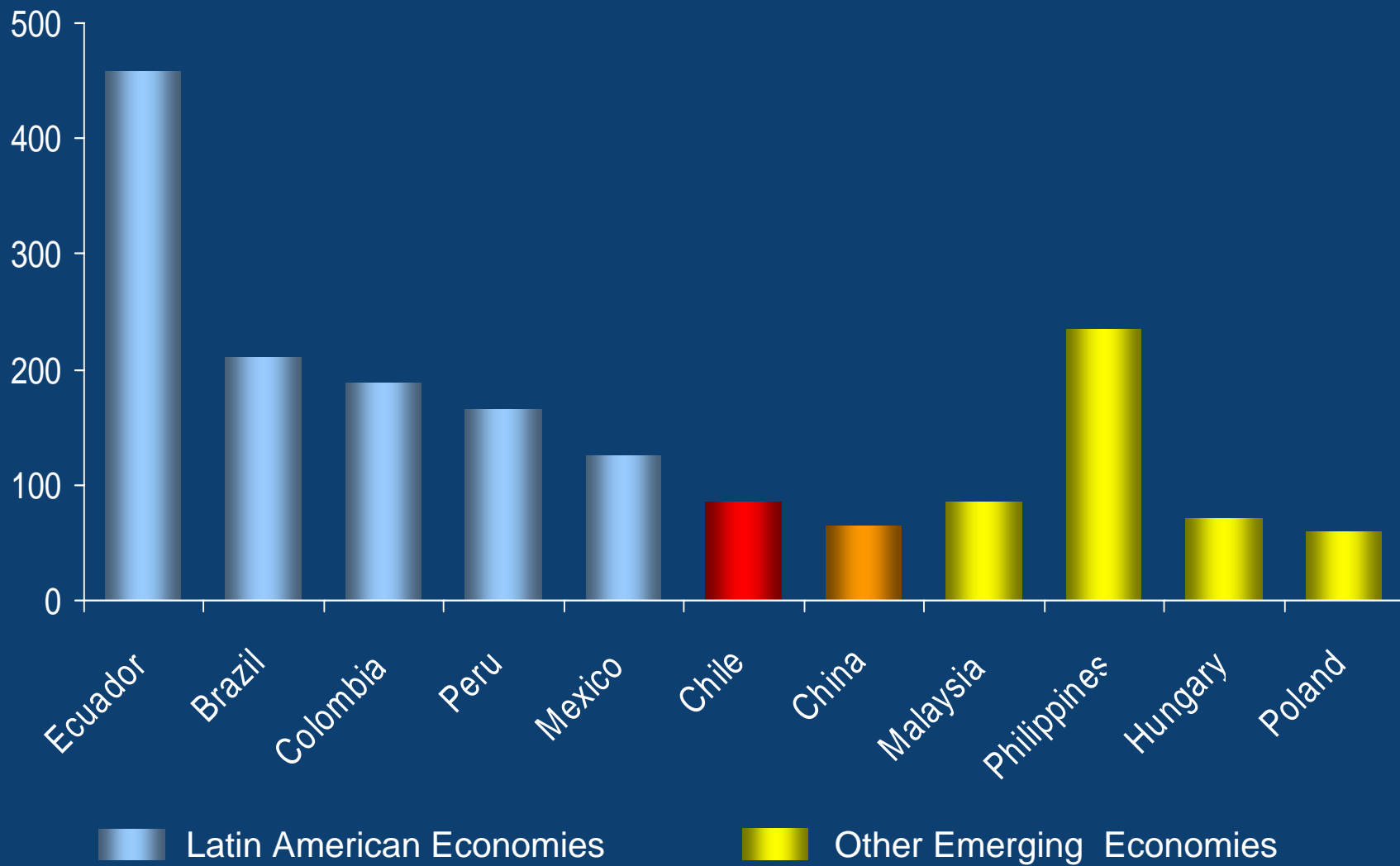
(2005)



Note: The competitiveness index measures country's ability to achieve high and sustainable per capita GDP growth.
 Source: World Economic Forum (2005).

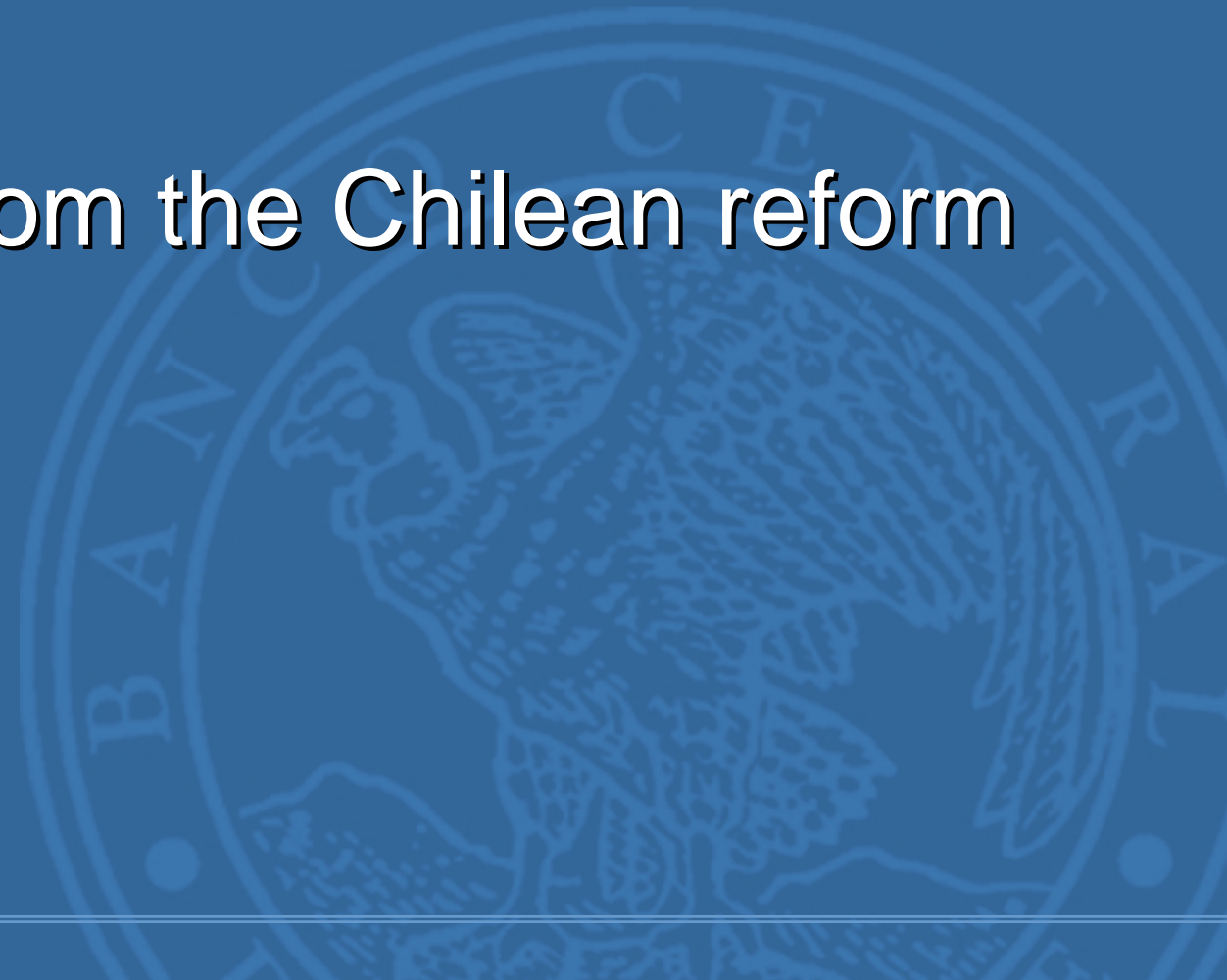
Country Risk

(As of August 18, 2006, bp)



Source: JP Morgan (2006).

4. Lessons from the Chilean reform



Lessons from the Chilean reform

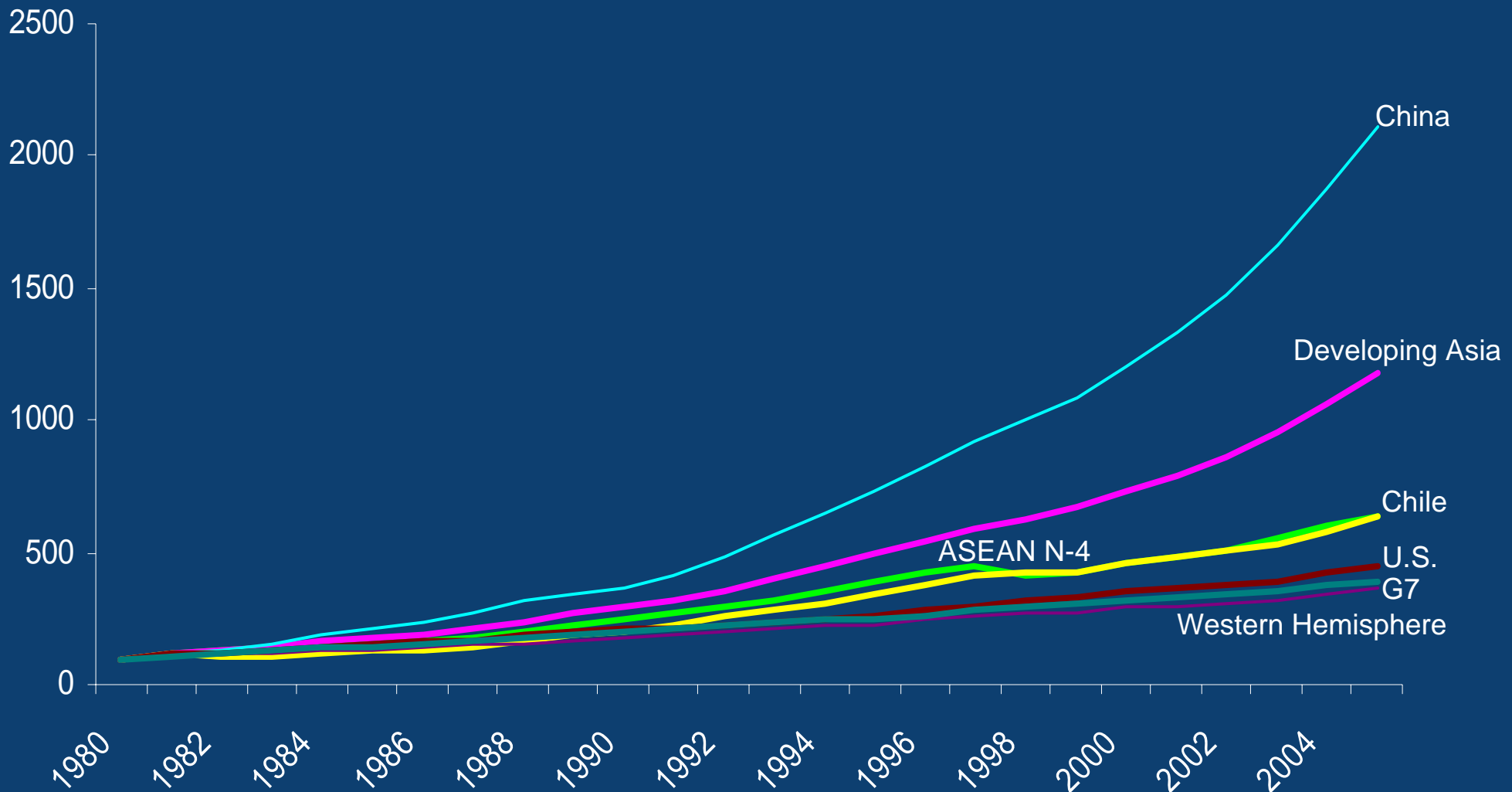
- Like Chile, China has a history of reforms. In the late seventies, several structural reforms were implemented oriented to foster competitive markets and integration to the world economy.
- In the eighties, market deregulation reforms:
 - ▲ Reducing monopolistic practices;
 - ▲ Reducing trade tariffs;
 - ▲ Abolishing government monopoly in export sector;
 - ▲ Eliminating multiple exchange rates, culminating with WTO membership.
- More recently:
 - ▲ Creation of incentives to attract foreign direct investment (1990s);
 - ▲ Protection of property rights (Constitutional amendment of 2004).

Lessons from the Chilean reform

- As a result, performance of the Chinese economy has been very impressive during the last twenty years:
 - ▲ Average growth rate: 9.7% (1985-2005) (pre-reform: 5.3% 1960-1978);
 - ▲ Real per capita GDP (PPP) increased by 700% (1985-2005);
 - ▲ FDI increased to US\$64.5 billion, and exports to US\$762 billion in 2005;
 - ▲ Extreme poverty was reduced by more than 400 million people;
 - ▲ Large productivity gains caused by reallocation of resources to more productive uses.
- China has increased its share of the world output from 3.5% in 1980 to 15.4% today, and is now the second largest economy in the world (PPP).

Real GDP

(PPP, Index 1980=100)



Source: WEO, Abril 2006.

Lessons from the Chilean reform

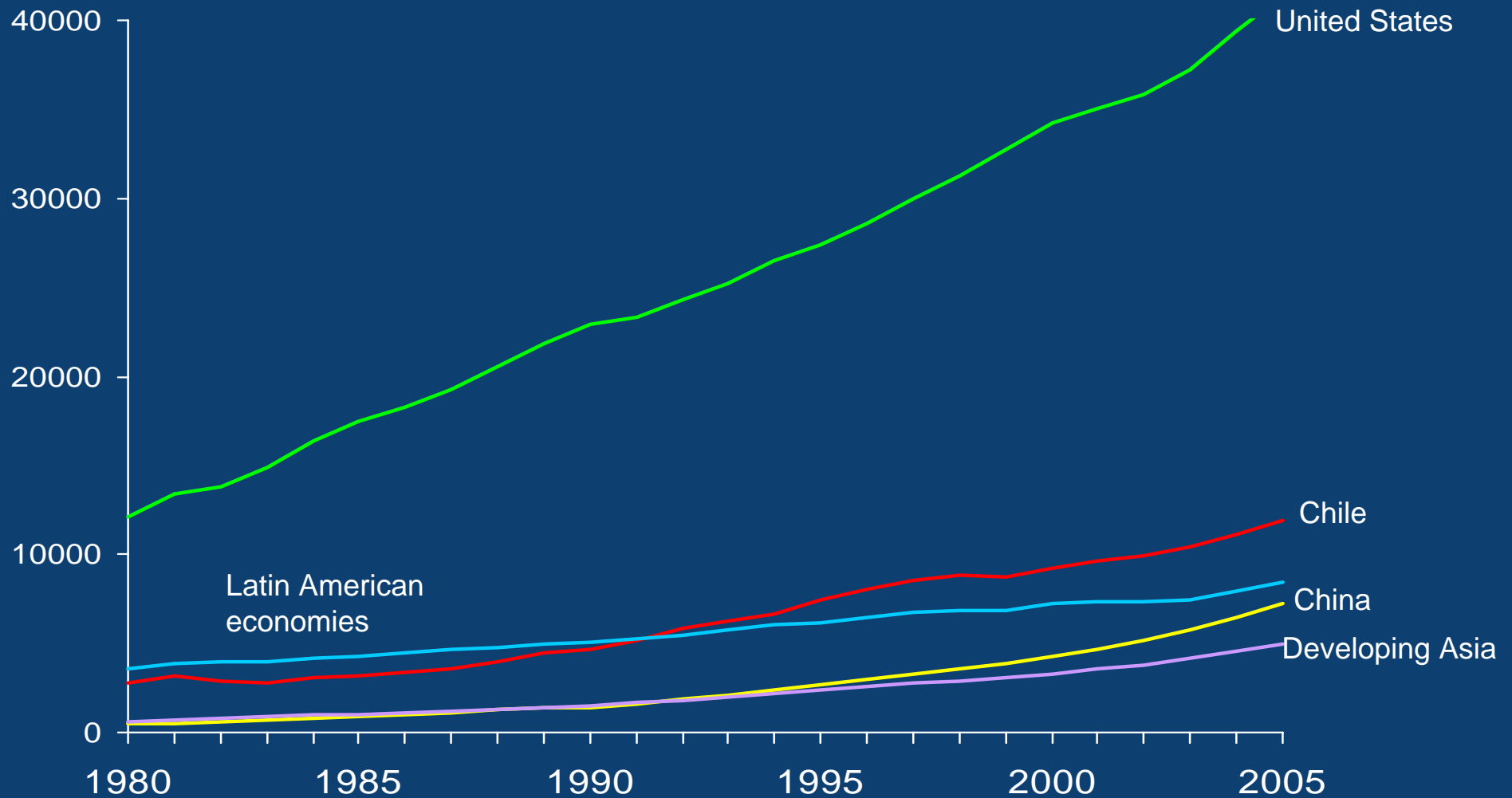
- Until now, growth performance in China has been sustained by:
 - ▲ The successful use of its working force with a low cost of labor;
 - ▲ A very high saving rate of nearly 50% of GDP (32% pre-reform saving rate);
 - ▲ Large-scale capital investment (financed by domestic savings and foreign investment);
 - ▲ The incorporation of foreign technology;
 - ▲ A very low initial per capita GDP (US\$637, PPP adjusted, in 1978).

Lessons from the Chilean reform

- However, its real per capita GDP (PPP) is still low; 54% of Chile's and 19% of G-7's per capita GDP.
 - ▲ China is poorer than many of its neighbors. The World Bank classified China as a lower-middle-income country.
 - ▲ This economy has much catching up to do.
- The challenges for Chinese authorities is to ensure that growth rates are sustainable over a long period.
- ¿What can be learned regarding sustainable economic growth from the Chilean experience?

Real Per Capita GDP

(PPP, billions US\$)



Source: WEO, Abril 2006.

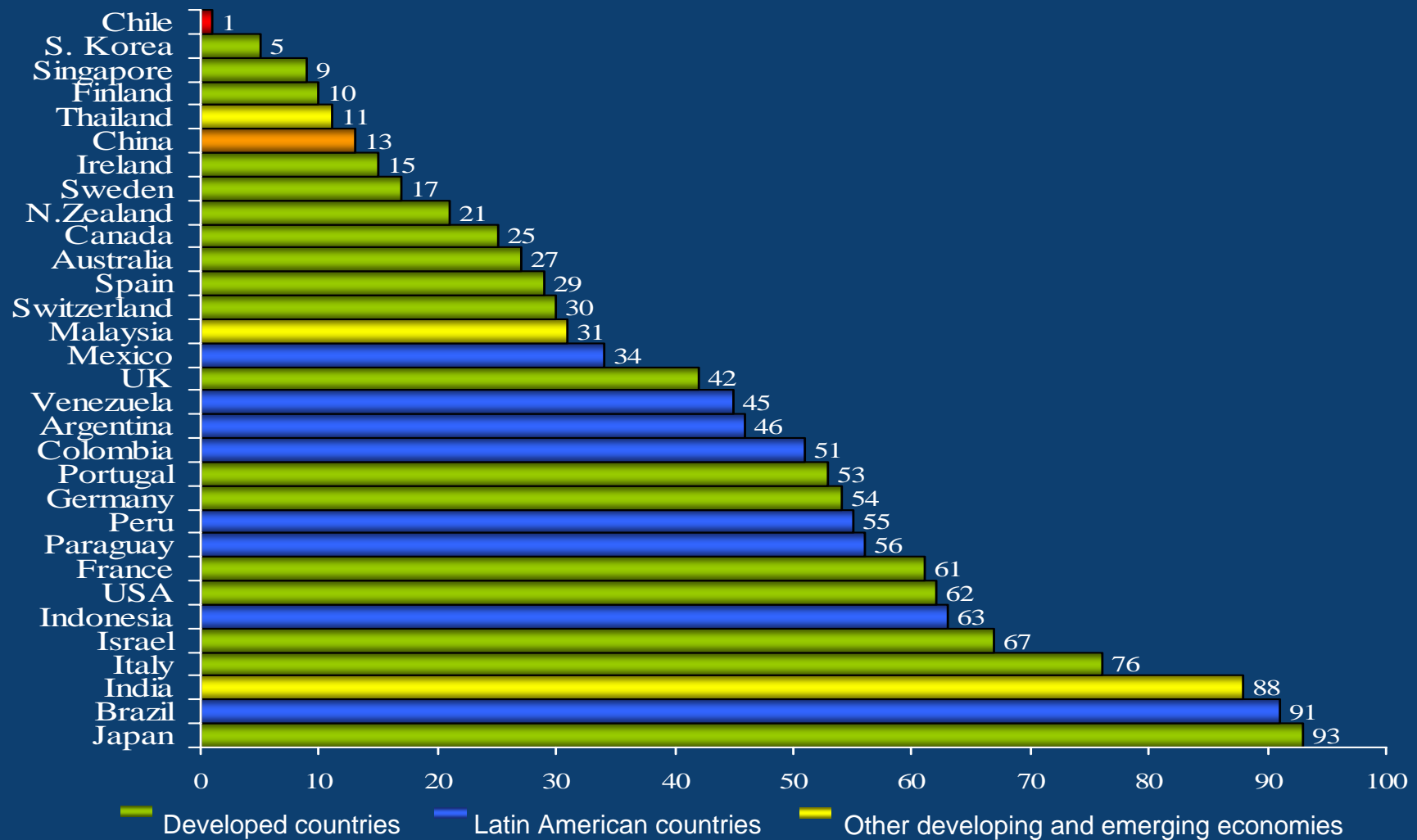
Lessons from the Chilean reform

- Chile's main explanation of its successful economic model is the buildup of five strong pillars:
 - ▲ A proved macroeconomic framework;
 - ▲ An open competitive economy;
 - ▲ A solid financial system;
 - ▲ Strong institutions (e.g., rule of law, independent Central Bank);
 - ▲ A comprehensive social network.
- Theoretical and empirical evidence also show that these pillars are the basis for sustained growth.

Lessons from the Chilean reform

- Chile's macroeconomic framework is consolidated and has proved to be consistent:
 - ▲ Fiscal rule of a structural surplus of 1% of GDP, with a very low public debt (a necessary condition);
 - ▲ Floating exchange rate system;
 - ▲ Inflation targeting monetary framework.
- China has some room to improve its macroeconomic framework.

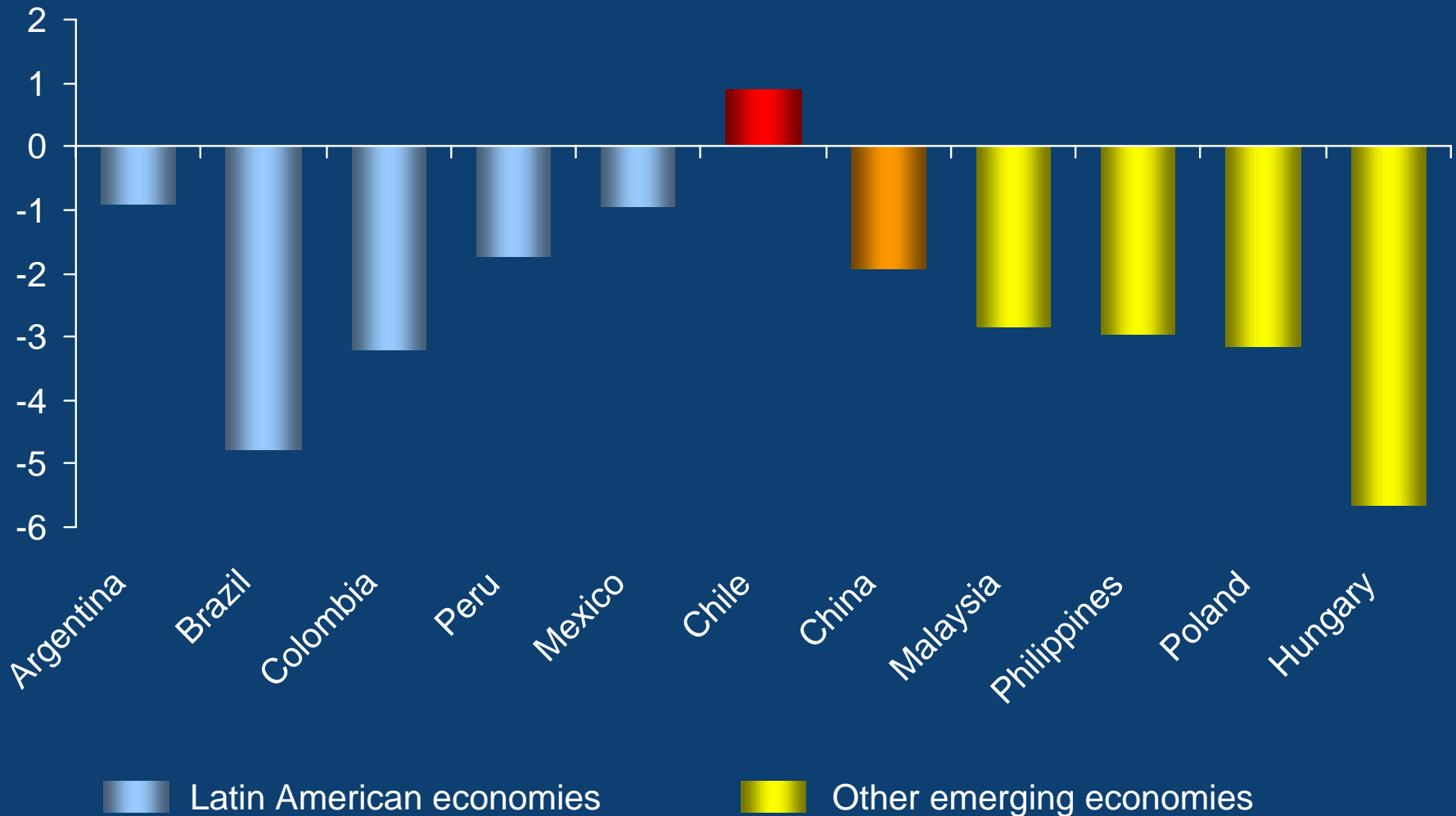
Macroeconomic Management (2005 ranking)



Source: The Global Competitiveness Report 2005-2006.

Fiscal Balance

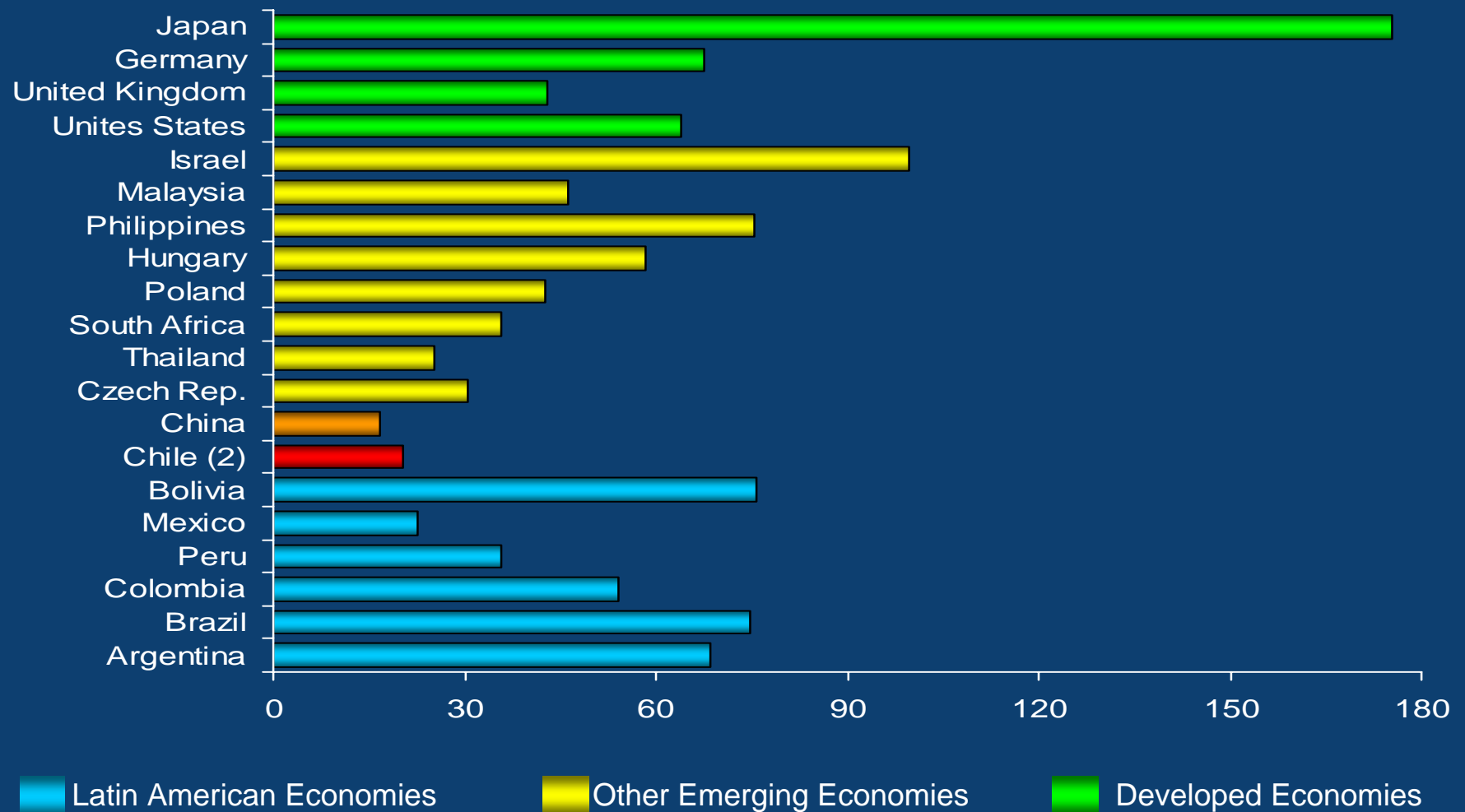
(1995-2005 annual average, % GDP)



Sources: Moody's, Ministry of Finance of Chile.

Public Debt 2005 ⁽¹⁾

(% GDP)

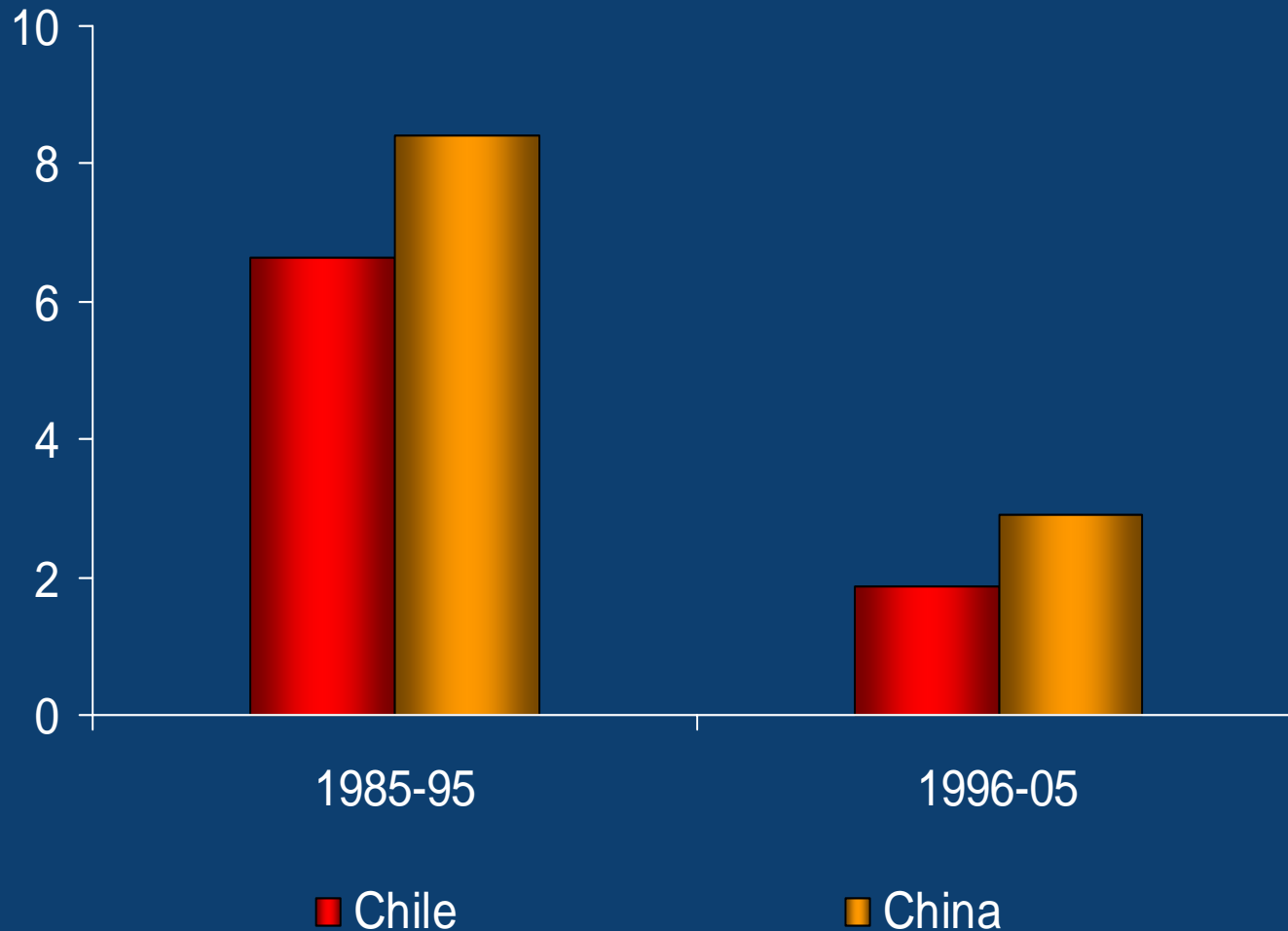


(1) General Government Debt. (2) As of March 2006.

Sources: Moody's and Ministry of Finance of Chile.

Inflation Volatility

(average of period, standard deviation monthly inflation yoy , %)



Lessons from the Chilean reform

What do we know with regards to macro policy?

- Fiscal responsibility is required:
 - ▲ Fiscal solvency in China is not a problem in the short run.
 - ▲ However, substantial medium-term fiscal obligations related to the unfunded liabilities of the state pension system, and the rising expenditure pressures for education, health and other social needs, might create heavy fiscal pressures.

Lessons from the Chilean reform

Exchange rate system:

- **Adjustable pegs** are prone to speculative attacks;
- Capital controls are ineffective to reduce external vulnerability;
- With *de facto* high capital mobility, adjustable pegs are difficult to defend;
- A **float** allows an easier adjustment of the RER to shocks;
- Reduces the volatility of short term flows;
- Allows the effective use of MP to accommodate real shocks;
- **Hard-peg** requires conditions which are difficult to achieve for an emerging market economy.

Lessons from the Chilean reform

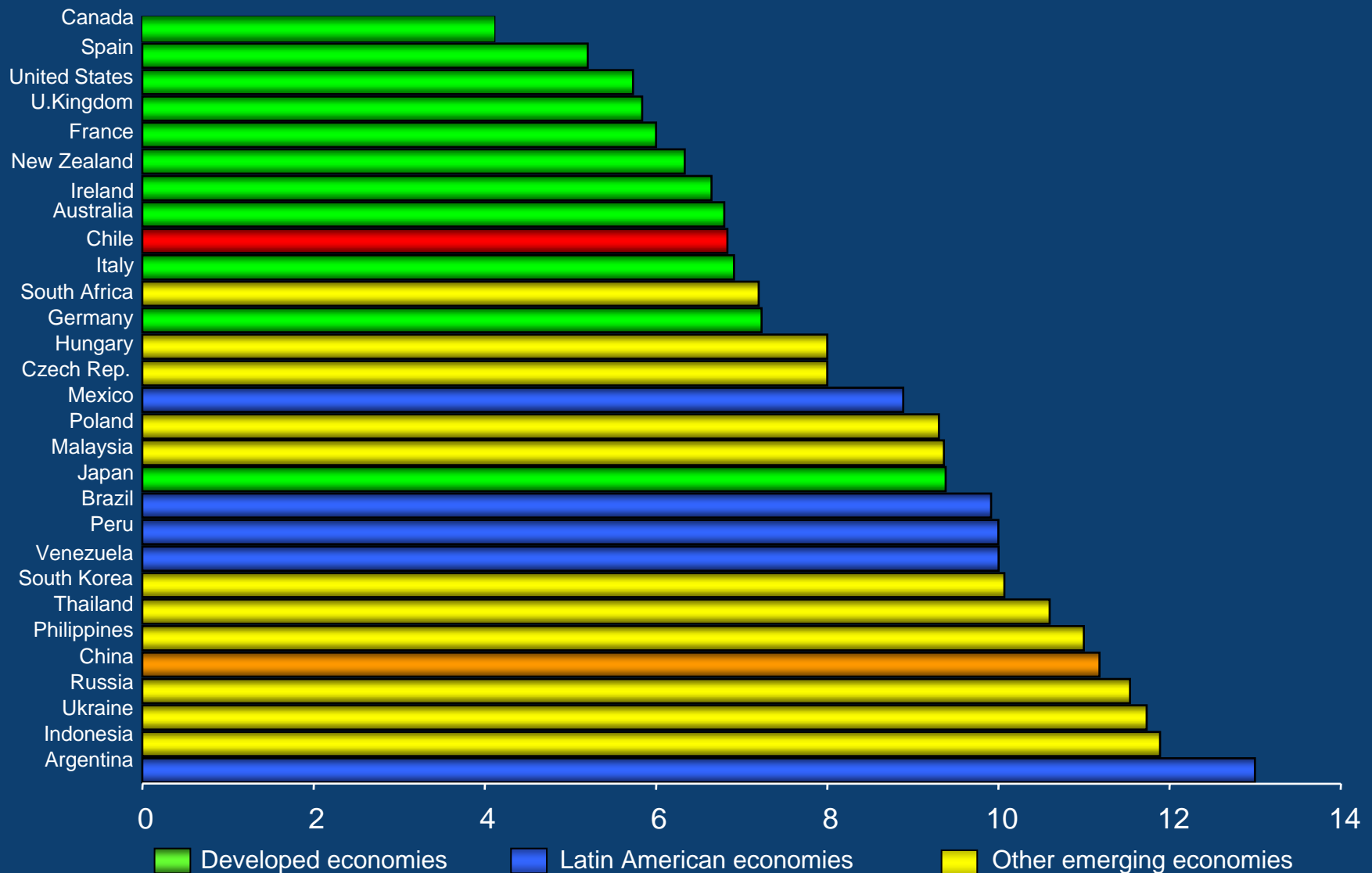
- The current exchange rate regime in China makes it difficult to use monetary policy as a counter-inflationary tool.
- Greater flexibility would be desirable to increase independence of the monetary policy to offset domestic and external shocks.

Lessons from the Chilean reform

Banking System:

- Important reforms to the Chilean financial system —that lasted twenty years and continue today— have contributed to making its banking system robust and comparable with some European developed countries.
- China can still improve: better regulation and supervision of financial system are required.

Banking Sector Strength (2006)



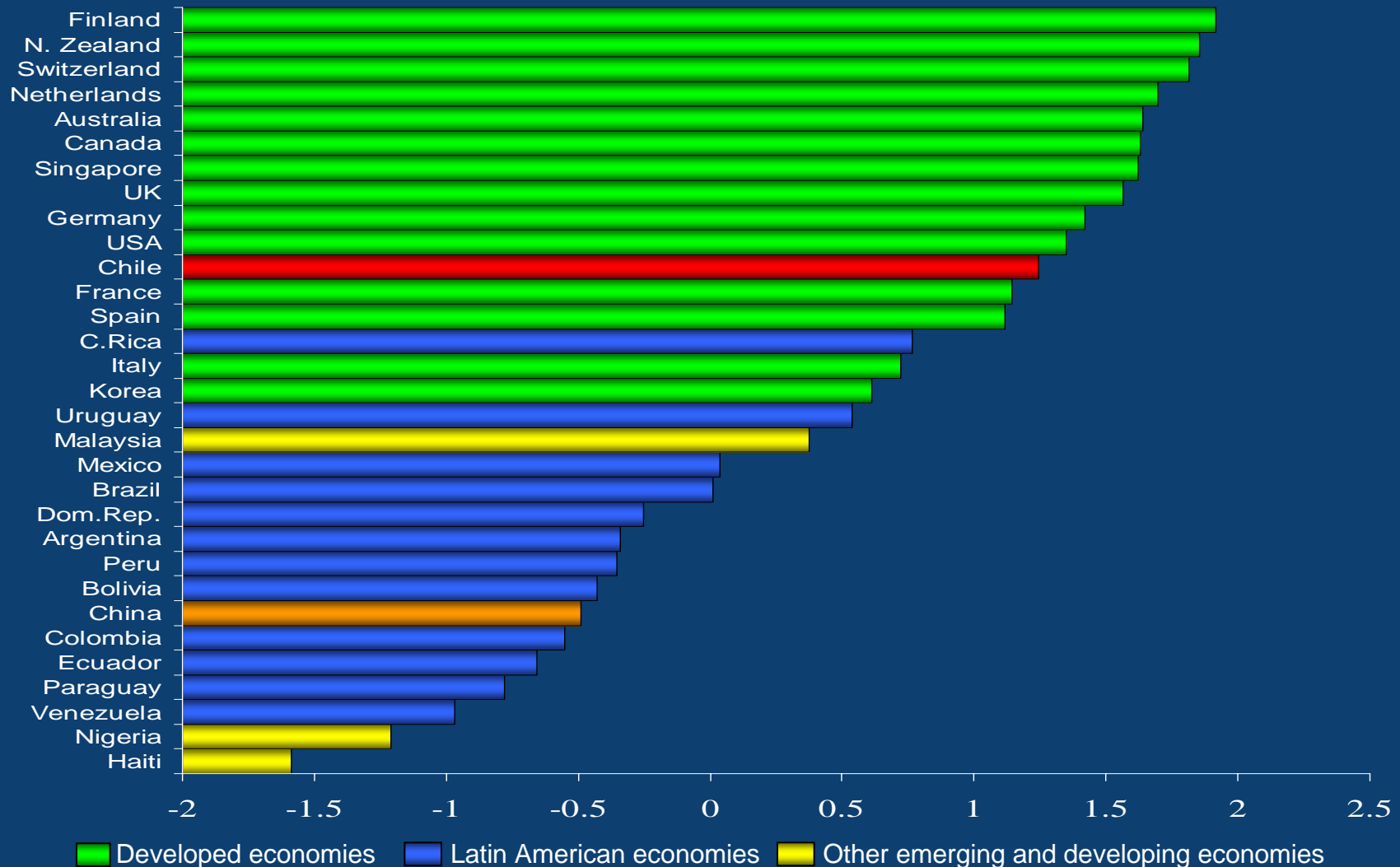
Source: Central Bank of Chile (based on Moody's Financial Strength Ranking).

Lessons from the Chilean reform

Institutional build up:

- Strong institutions are important to give credibility and effectiveness to economic policies:
 - ▲ Business climate;
 - ▲ Bureaucracy;
 - ▲ Rule of law;
 - ▲ Control of corruption, etc.

Quality of Institutions (2004)

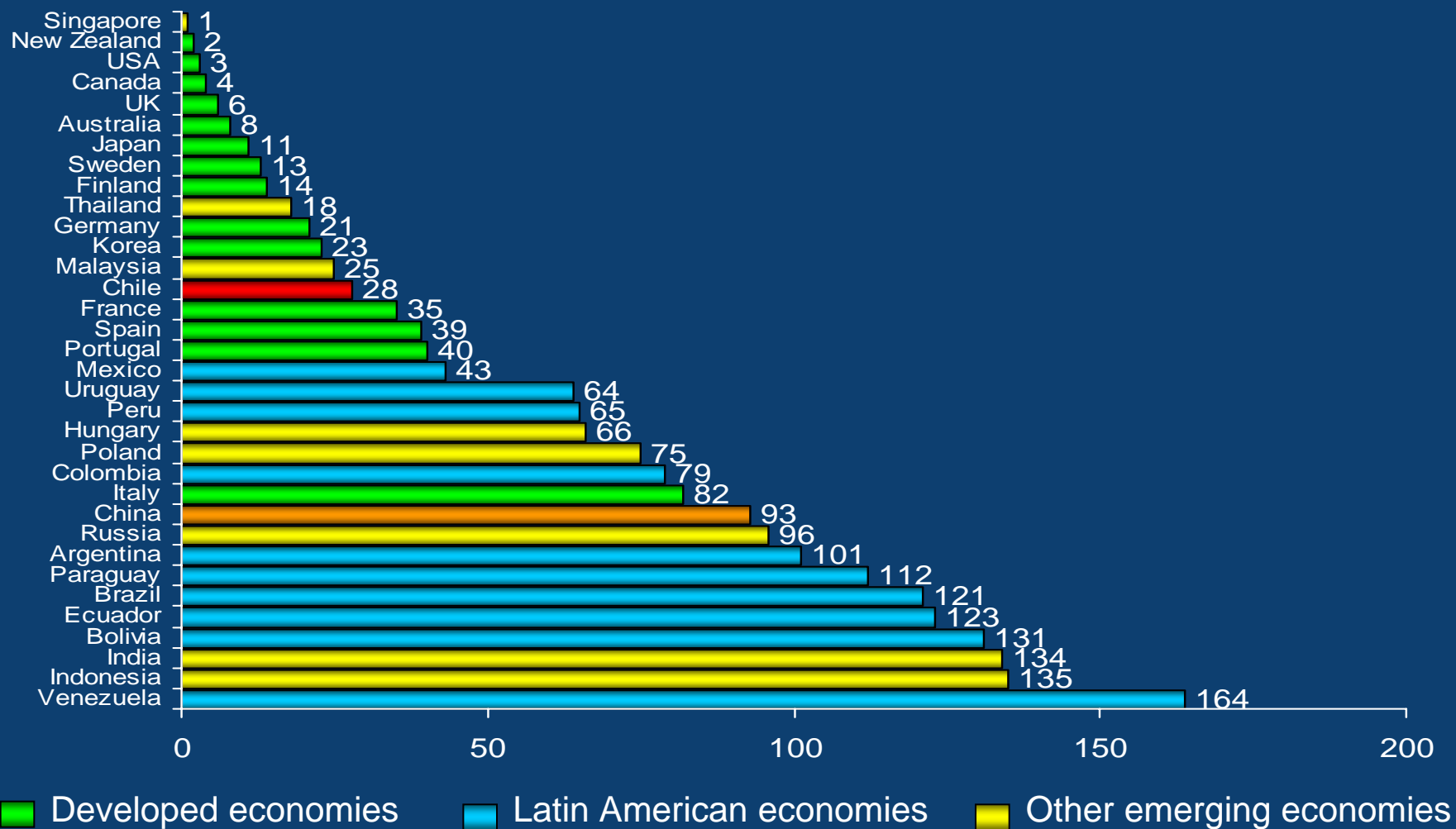


Source: World Bank (2005).

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

Ease of Doing Business

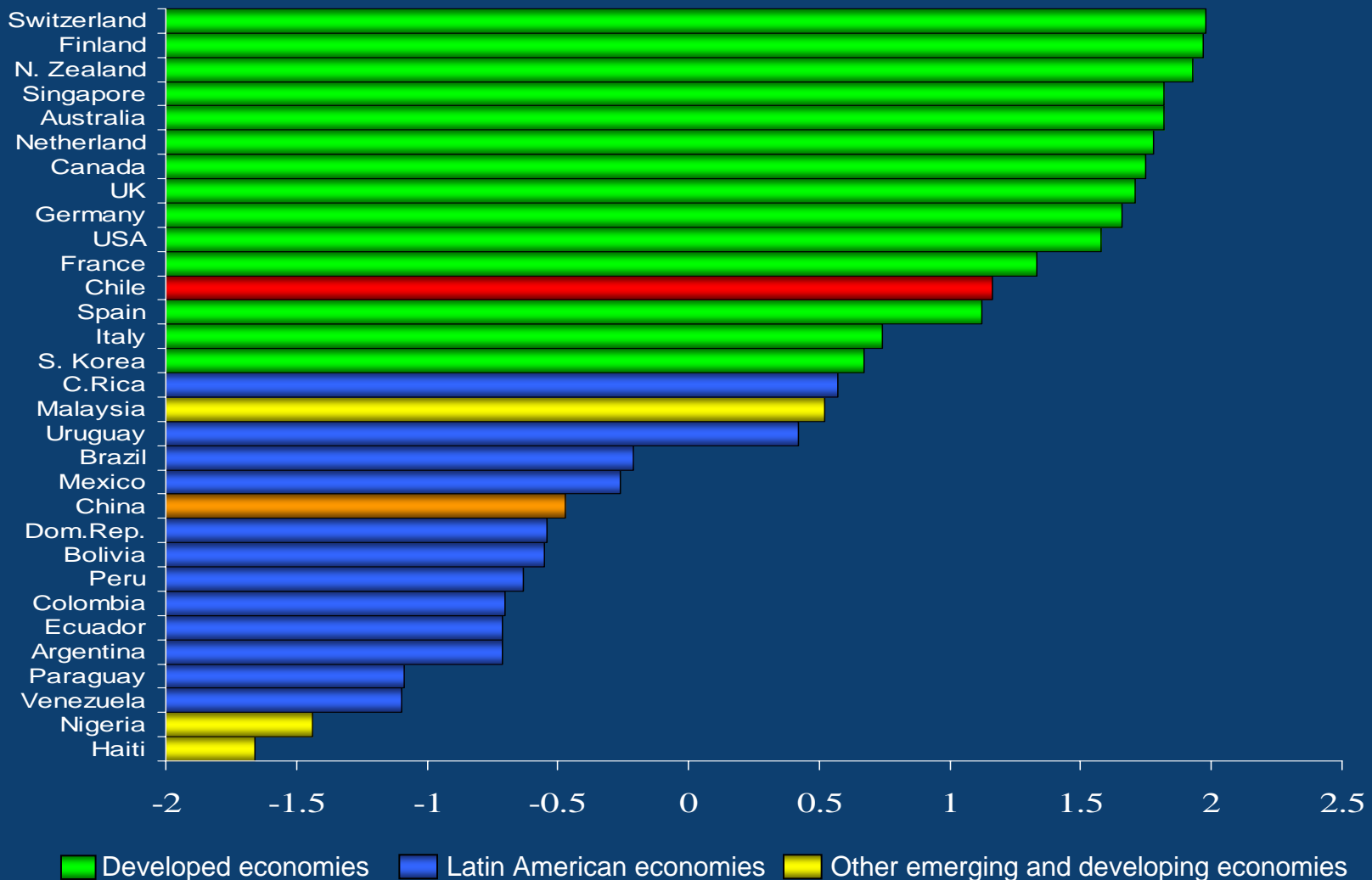
(2006)



Note: The ranking on ease of doing business averages country indicators across ten topics: starting a business, dealing with licenses, hiring and firing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business.

Source: World Bank (2006).

Rule of Law (2004)



Note: Index measures protection of individuals and property against violence or theft, independent and effective judges, and contract enforcement.
Source: World Bank (2005).

Lessons from the Chilean reform

- Broad and efficient social safety networks are required to ease social costs of enterprise restructuring and promoting inter-sectoral reallocation of labor, both from the public sector to the private sector, and from declining industries to growing industries.
- Social cohesion facilitates further reforms and sustainability of previous ones.

5. Conclusions



Conclusions

- Specific development strategies depend on initial conditions of each country.
- However, Chilean and other countries' experiences show that there are some key elements in achieving sustainable economic growth:
 - ▲ Macroeconomic stability with autonomous Central Bank and solvent fiscal sector;
 - ▲ Robust and sound financial sector;
 - ▲ Strong and stable institutional setting;
 - ▲ Competitive open-market economy;
 - ▲ Comprehensive social network.

Conclusions

- China has had an outstanding economic performance during the last twenty years, which has contributed to a remarkable reduction in poverty rate.
- However, it has still much more catching up to do.
- Advancing in building the above pillars would allow China to sustain high economic growth for a long time.
- And as a consequence, it would accelerate its per capita GDP, improving remarkably the welfare of its vast population.



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