



# 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

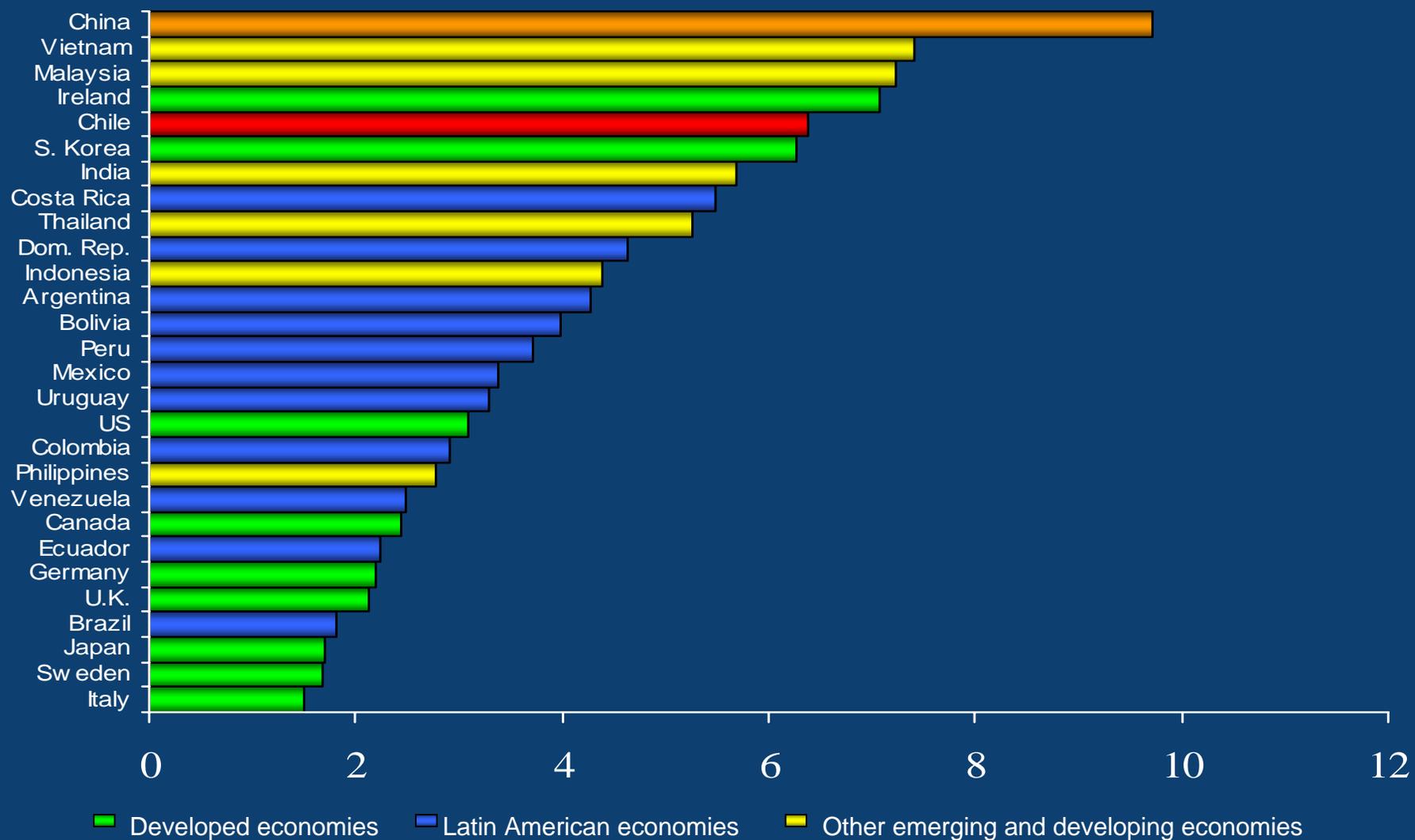


# Performance of the Chilean economy

- 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

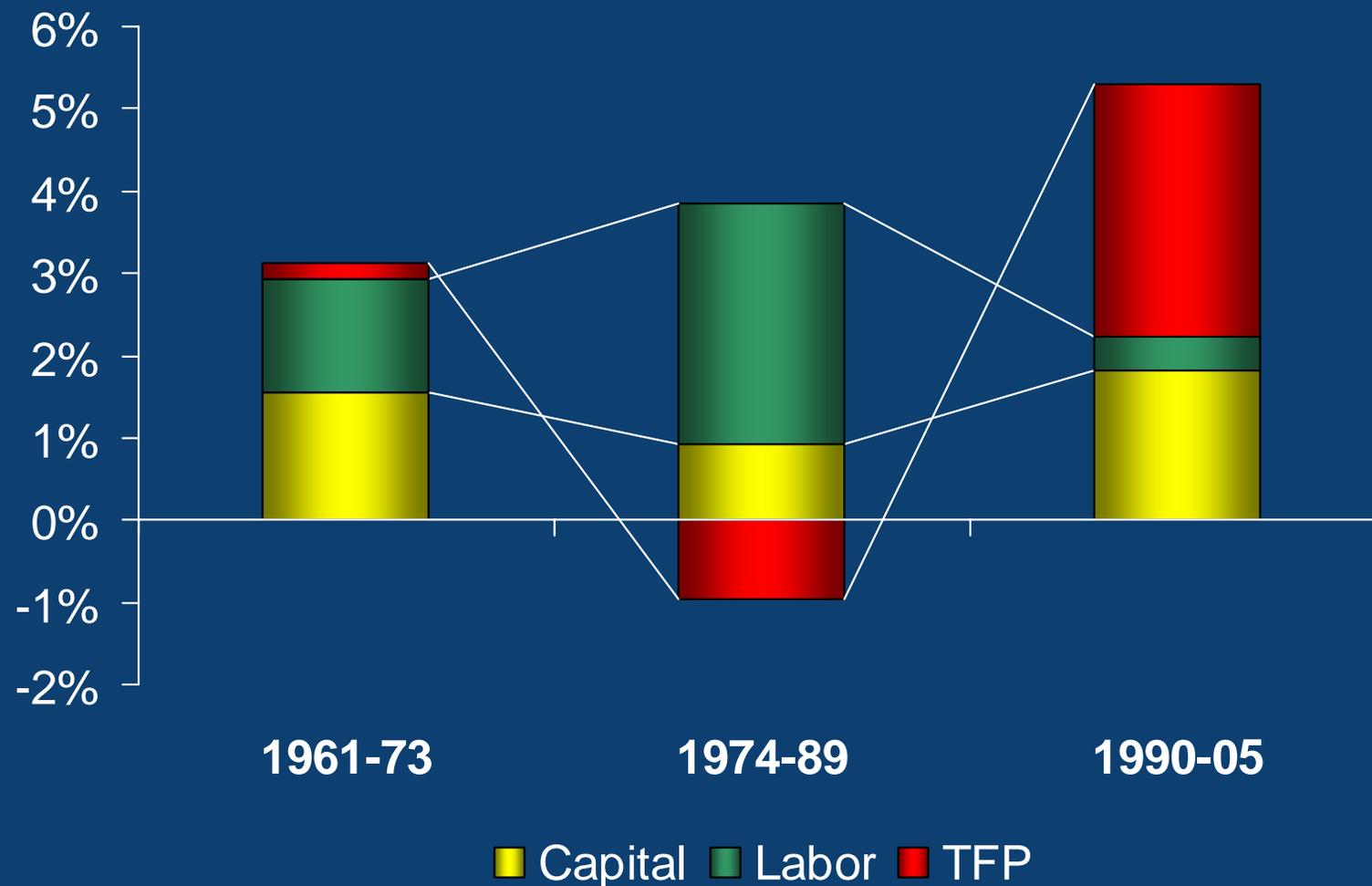
(% per annum)



Source: IMF (2005).

# Solow's Decomposition of Economic Growth

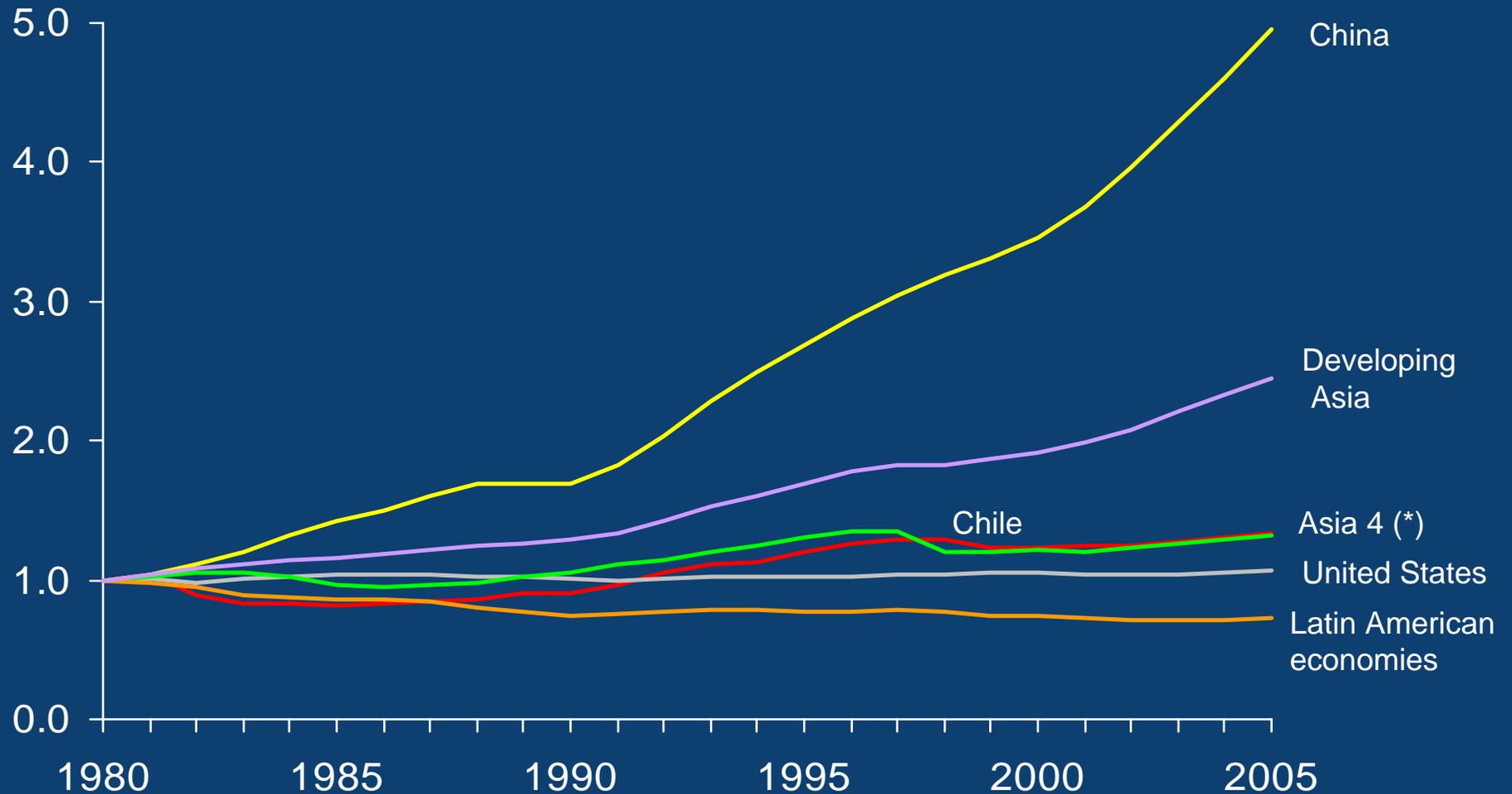
*(Chile: 1960-2005)*



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

# Relative Per Capita Output

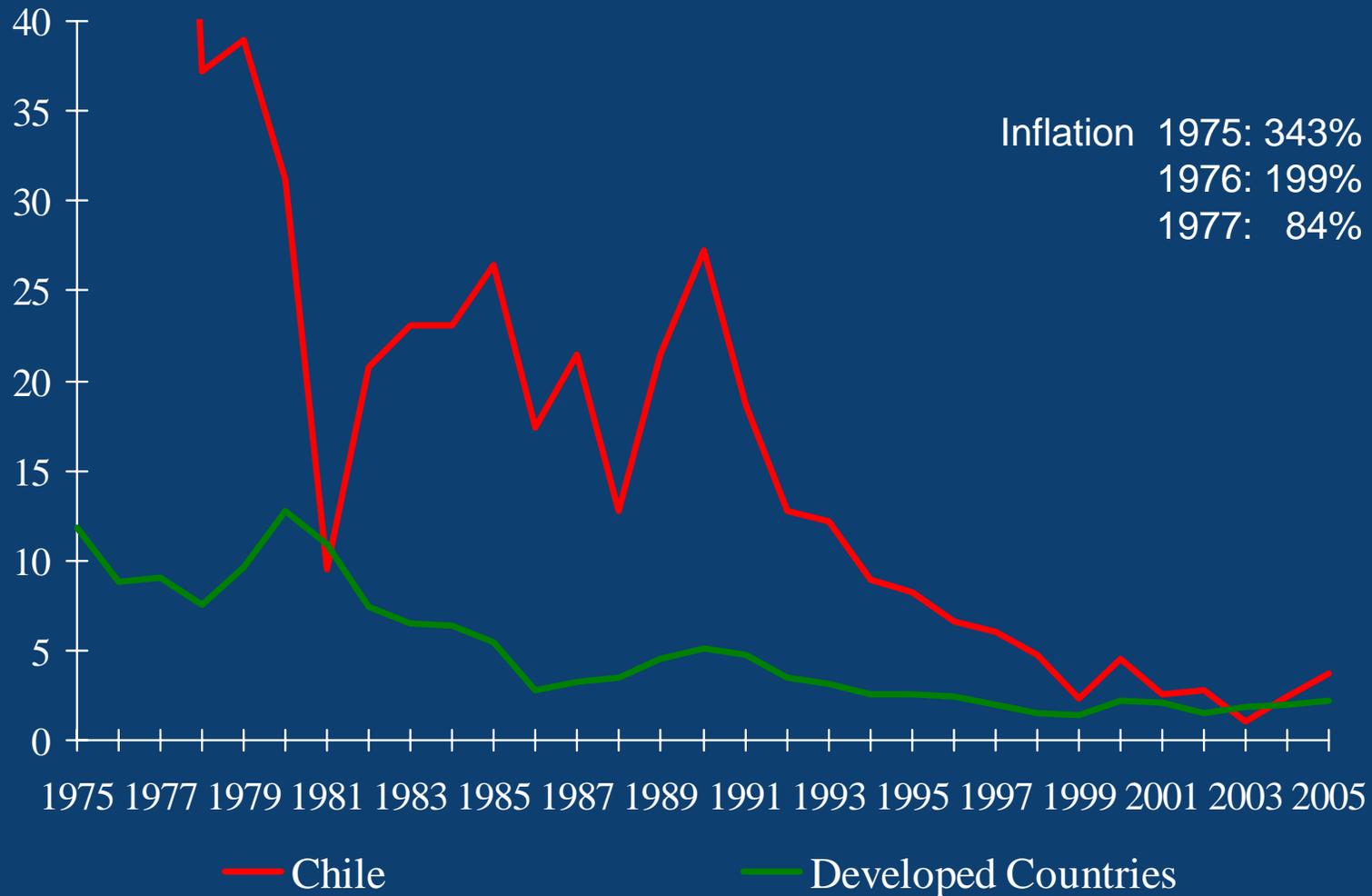
(per capita GDP in country j over per capita GDP of G-7, PPP; 1980=1)



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

# Inflation Rate

(%)



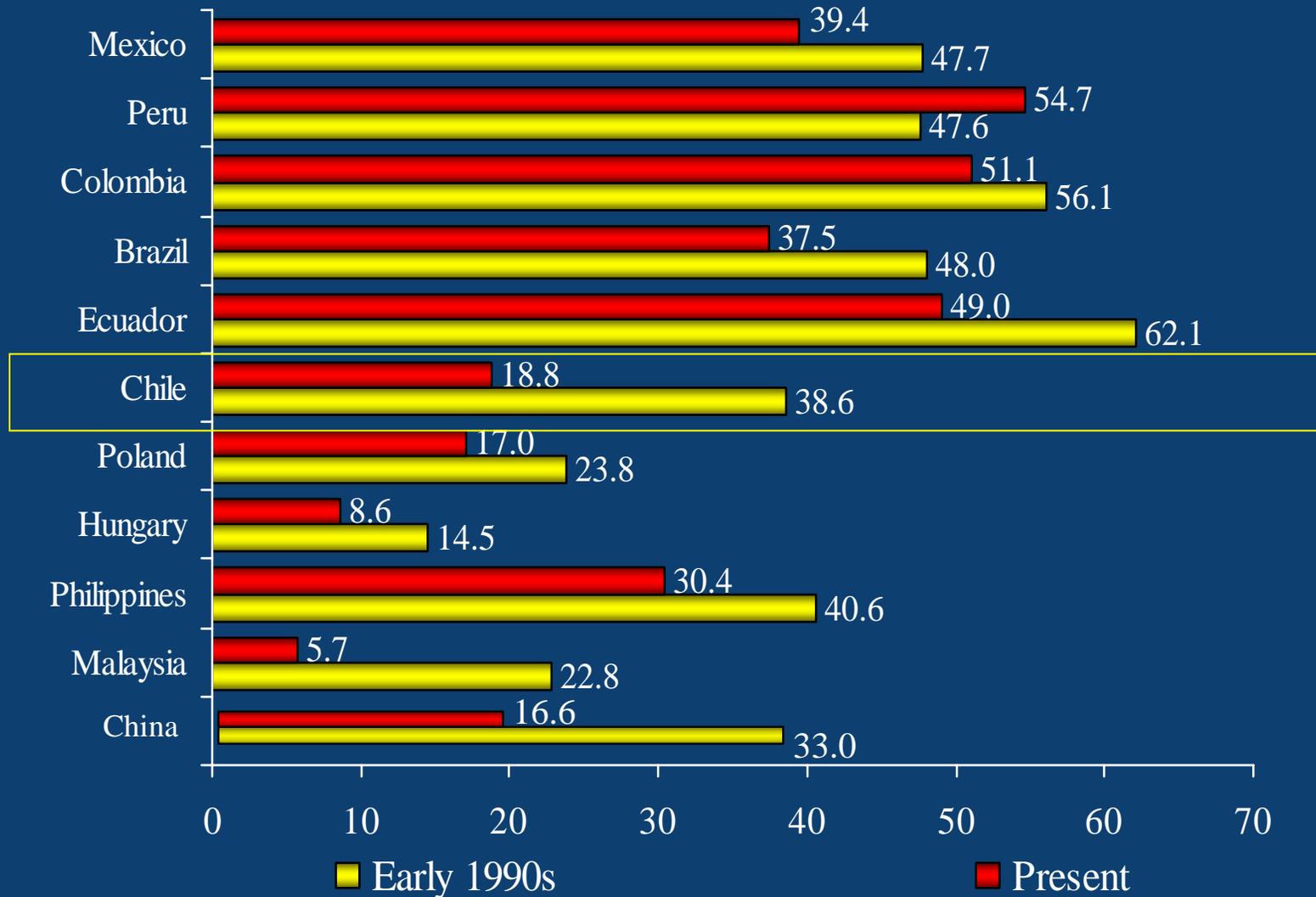
Source: Central Bank of Chile.

# 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

(%)

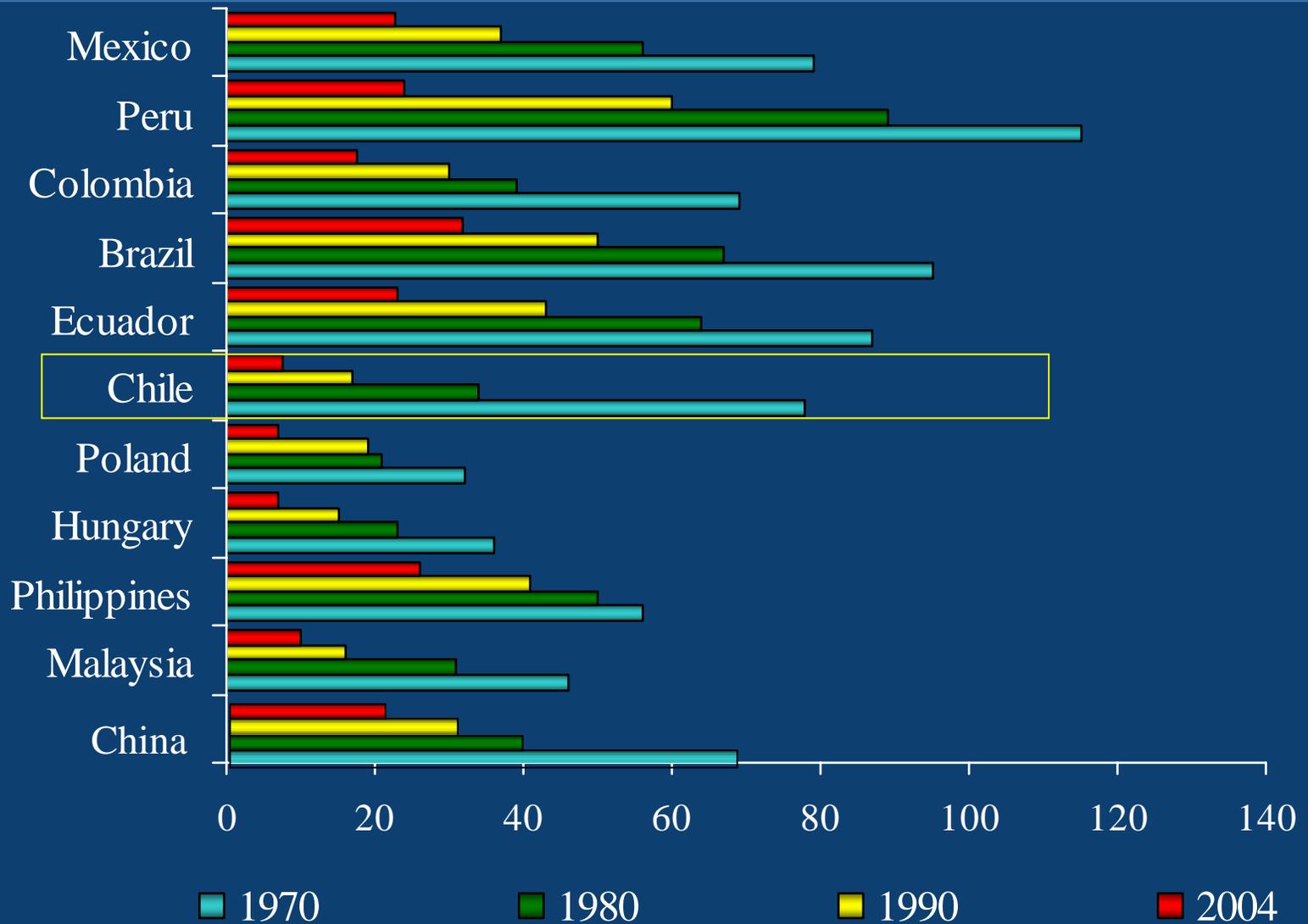


Note: Present stands for the years 2002 or 2003, depending on the country.

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

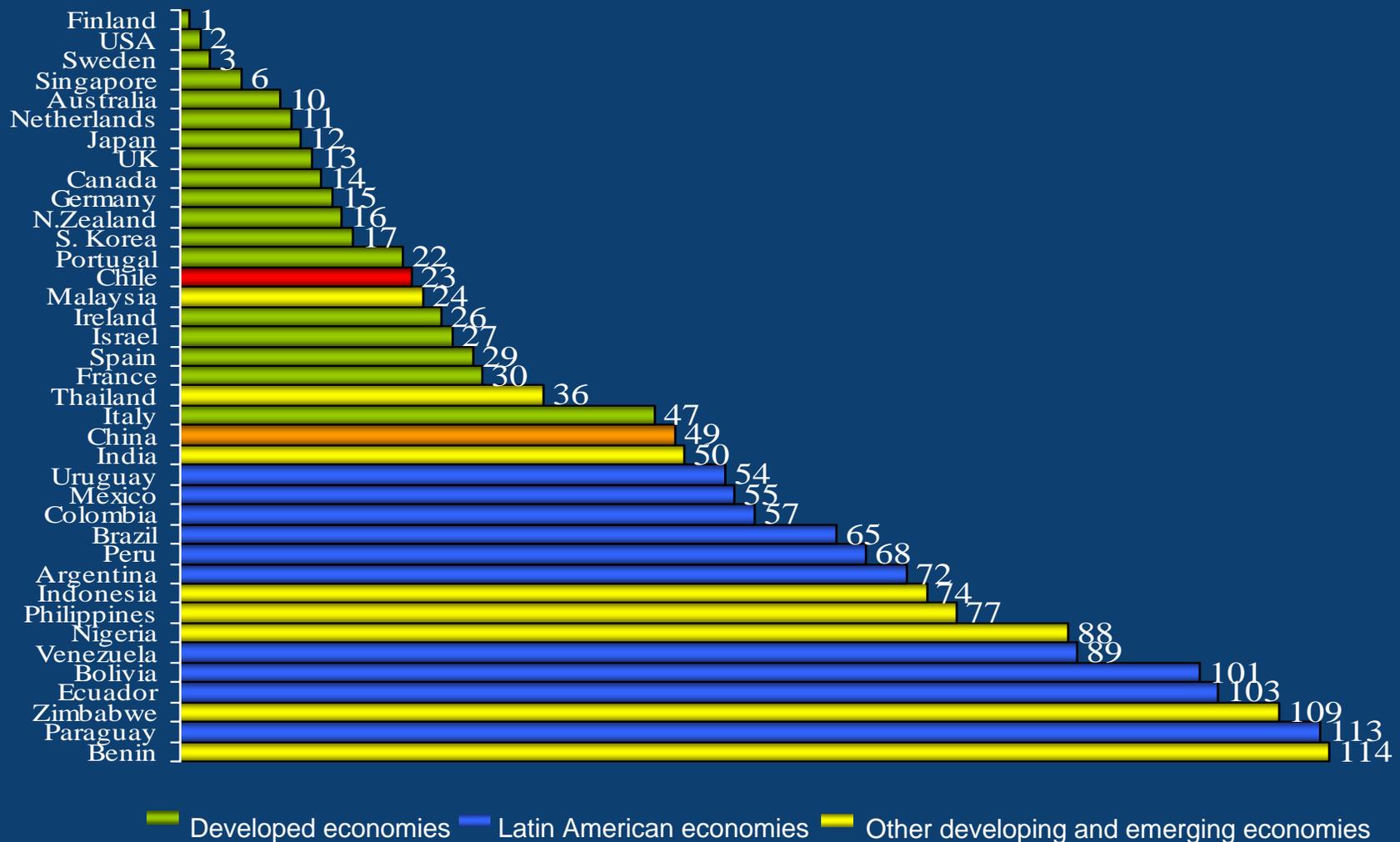
# Infant Mortality

(per 1000 born)



# Competitiveness

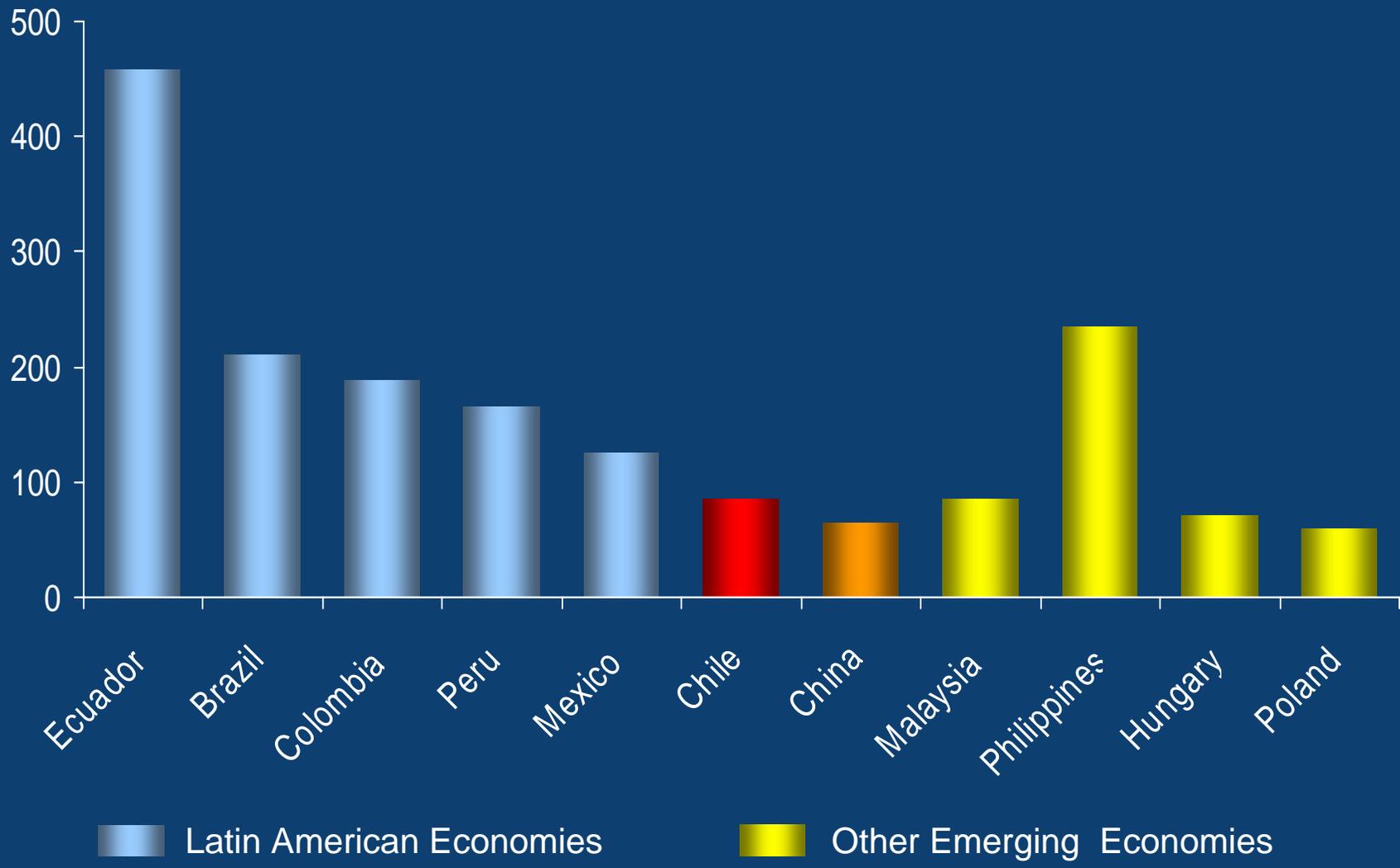
(2005)



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

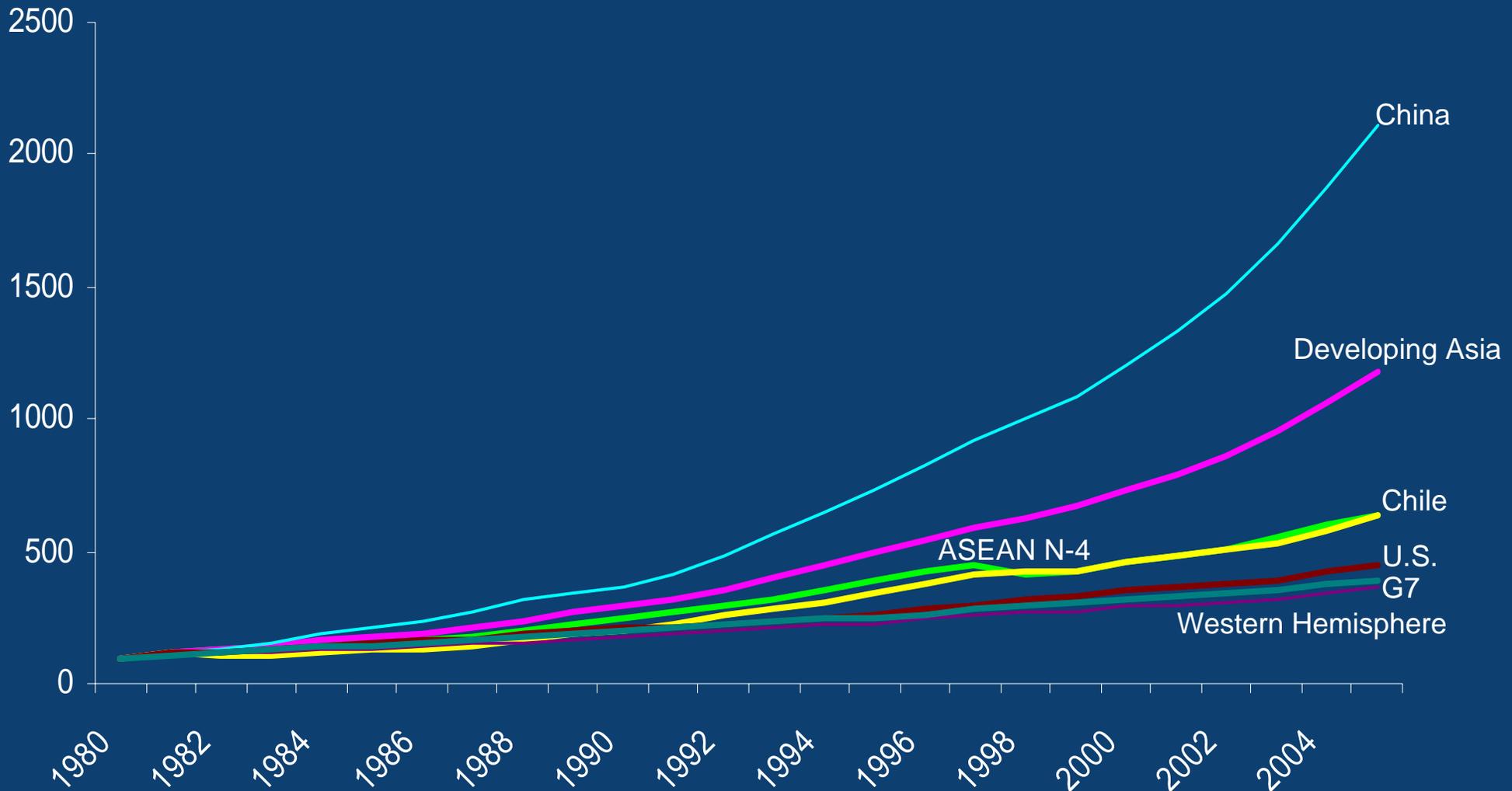
- Like Chile, China has a history of reforms. In the late seventies, several structural reforms were implemented oriented to foster competitive markets and integration to the world economy.
- In the eighties, market deregulation reforms:
  - ▲ Reducing monopolistic practices;
  - ▲ Reducing trade tariffs;
  - ▲ 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

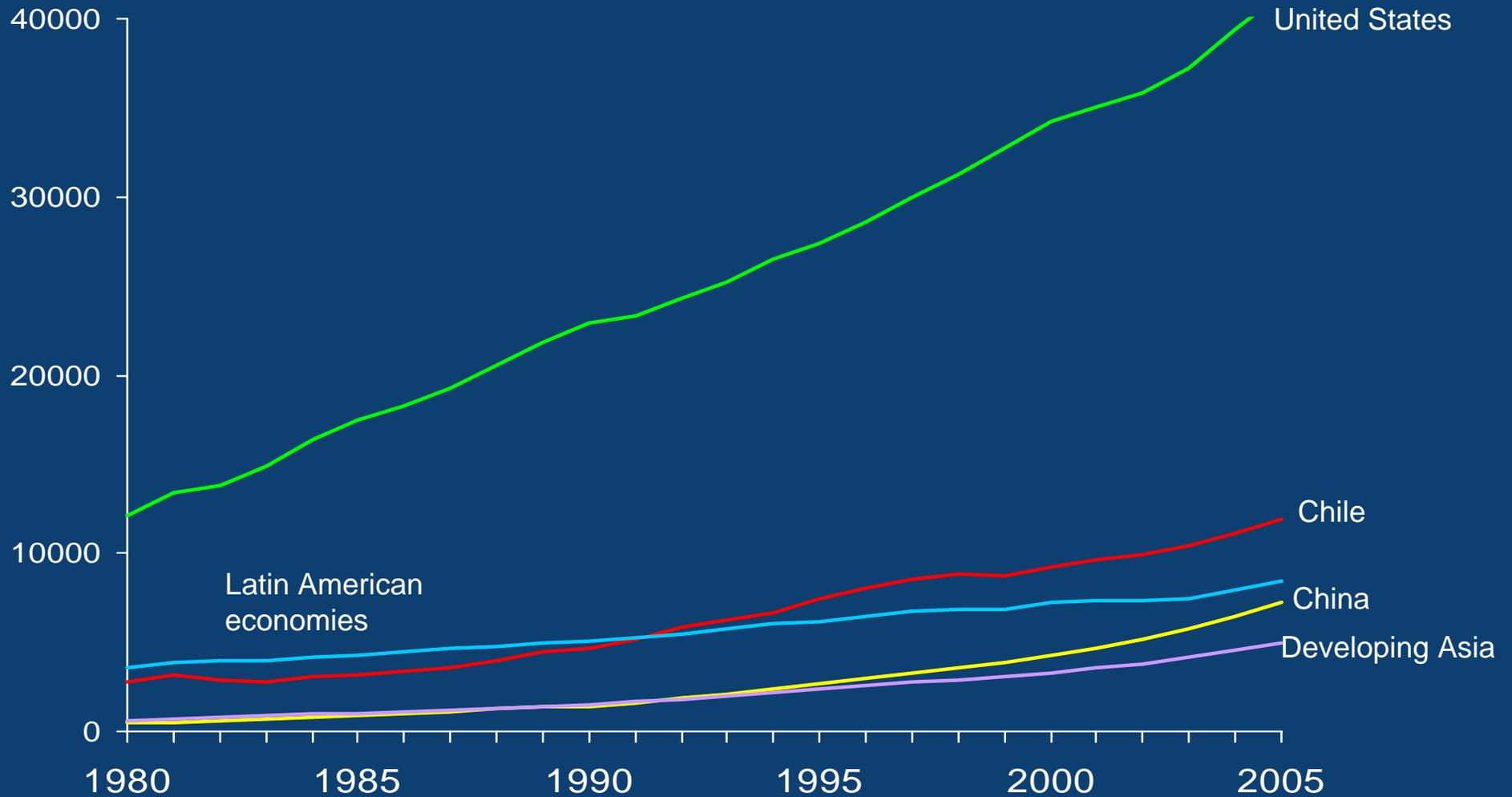
- Until now, growth performance in China has been sustained by:
  - ▲ The successful use of its working force with a low cost of labor;
  - ▲ A very high saving rate of nearly 50% of GDP (32% pre-reform saving rate);
  - ▲ Large-scale capital investment (financed by domestic savings and foreign investment);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

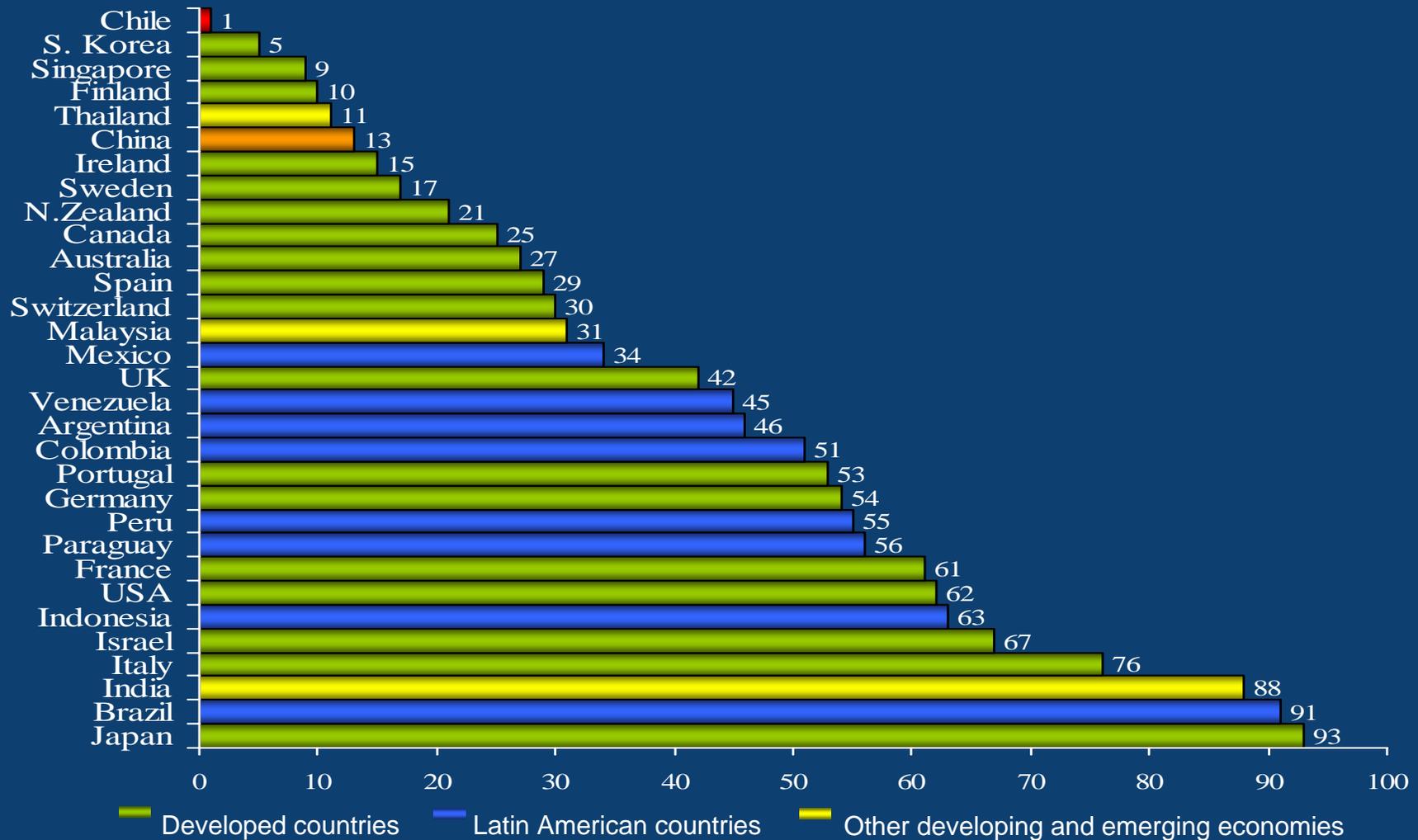
# Lessons from the Chilean reform

- 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.

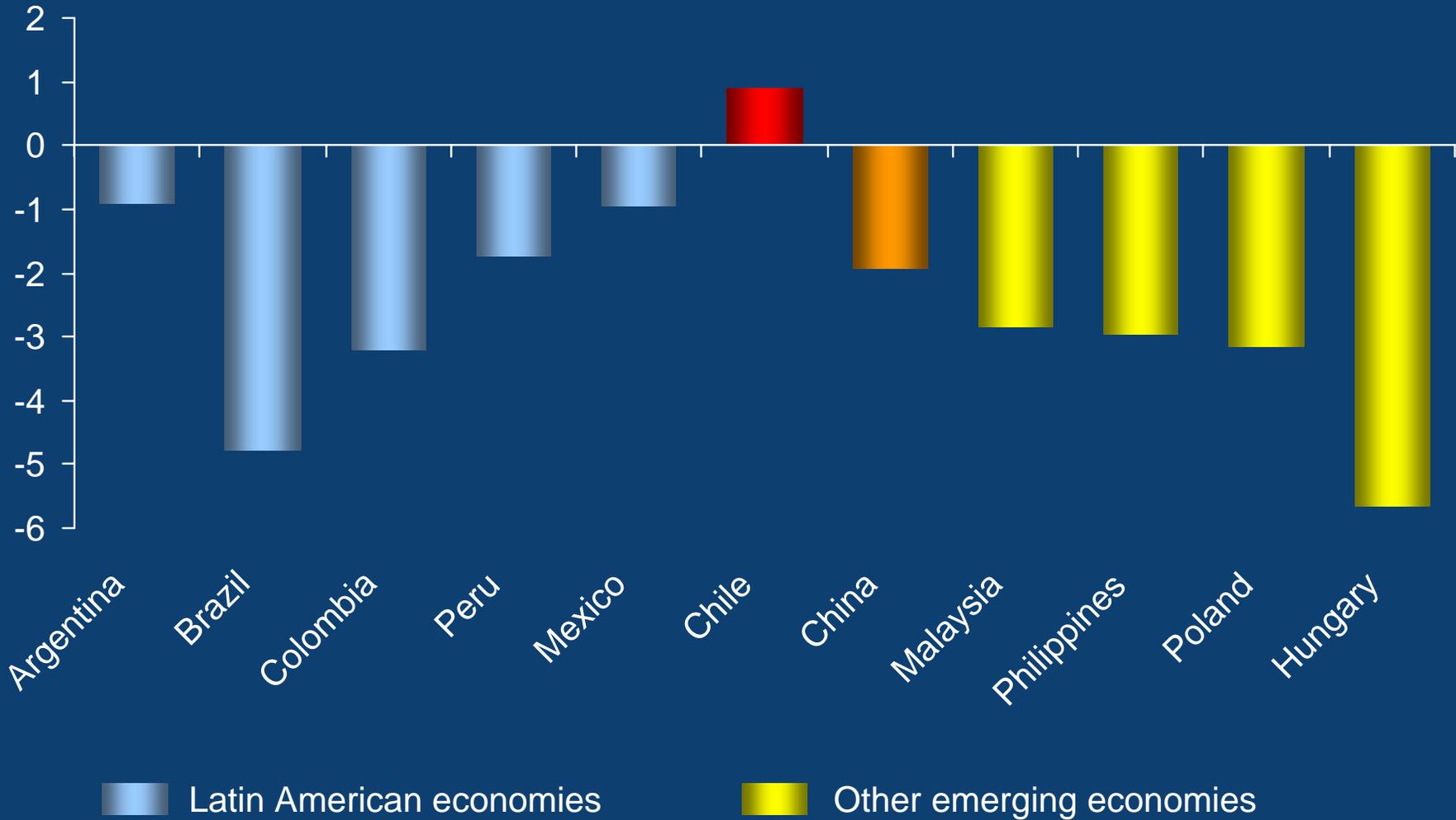
# Macroeconomic Management (2005 ranking)



Source: The Global Competitiveness Report 2005-2006.

# Fiscal Balance

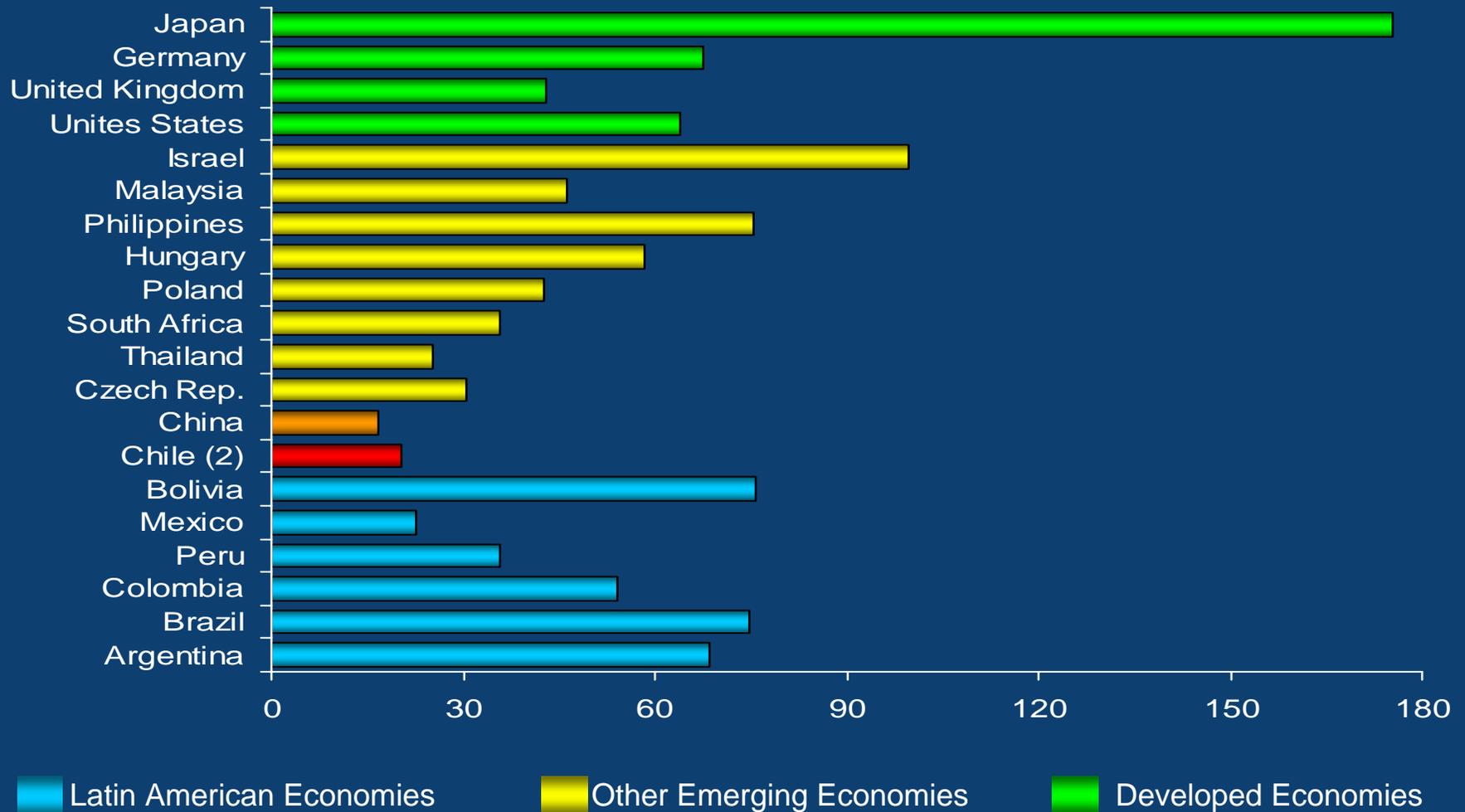
(1995-2005 annual average, % GDP)



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

# Public Debt 2005 (1)

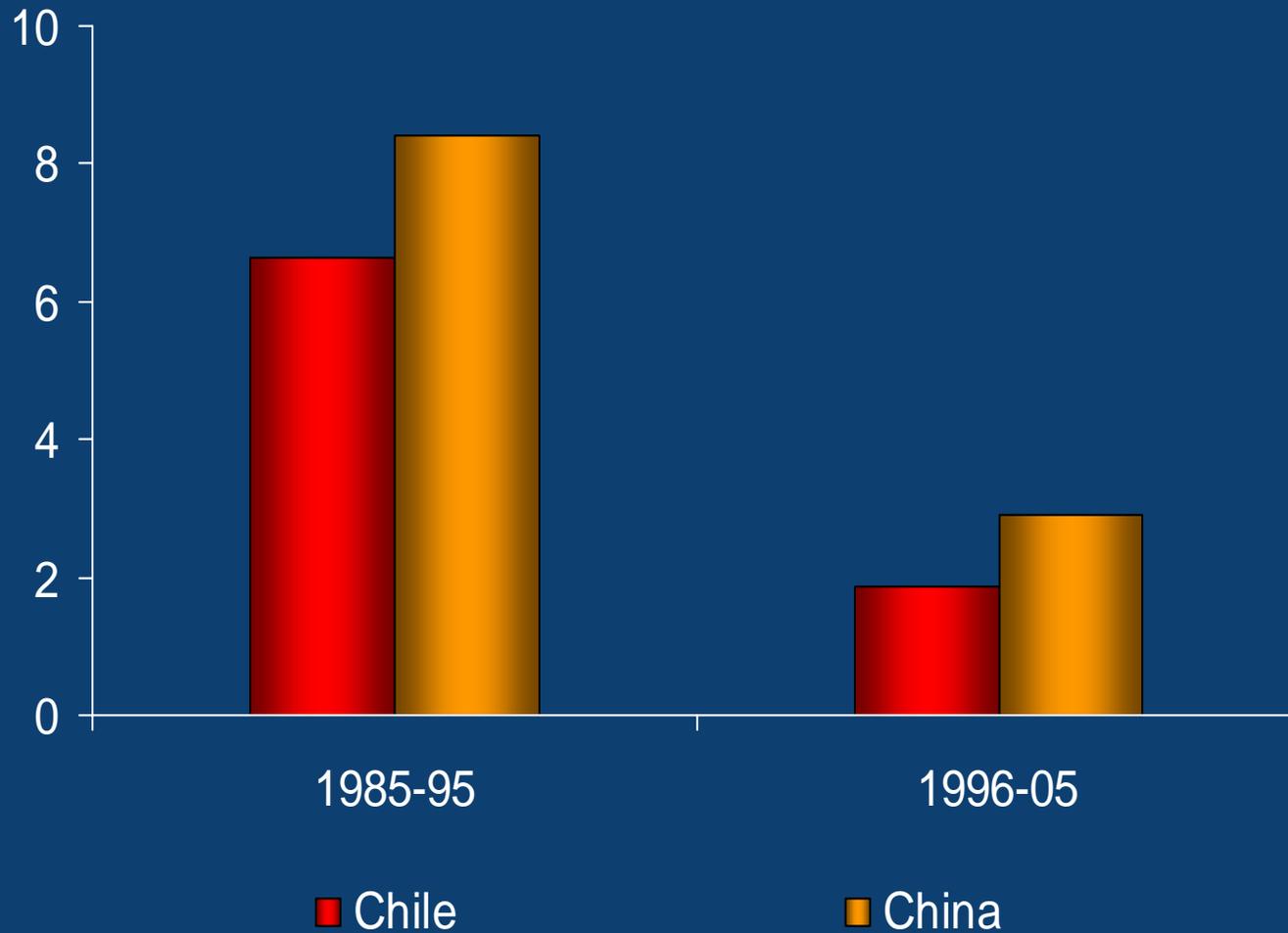
(% GDP)



(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

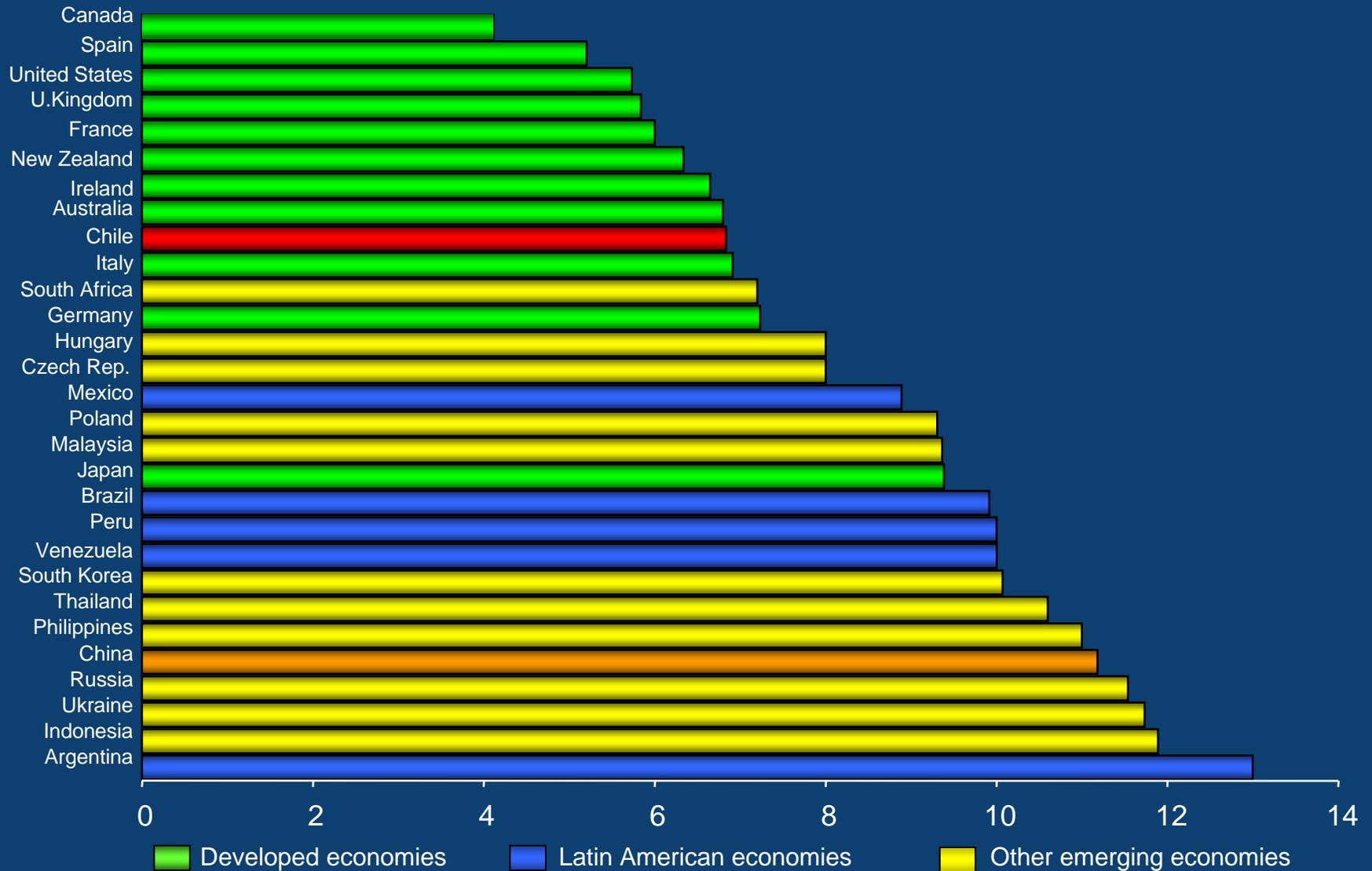
- The current exchange rate regime in China makes it difficult to use monetary policy as a counter-inflationary tool.
- Greater flexibility would be desirable to increase independence of the monetary policy to offset domestic and external shocks.

# 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)



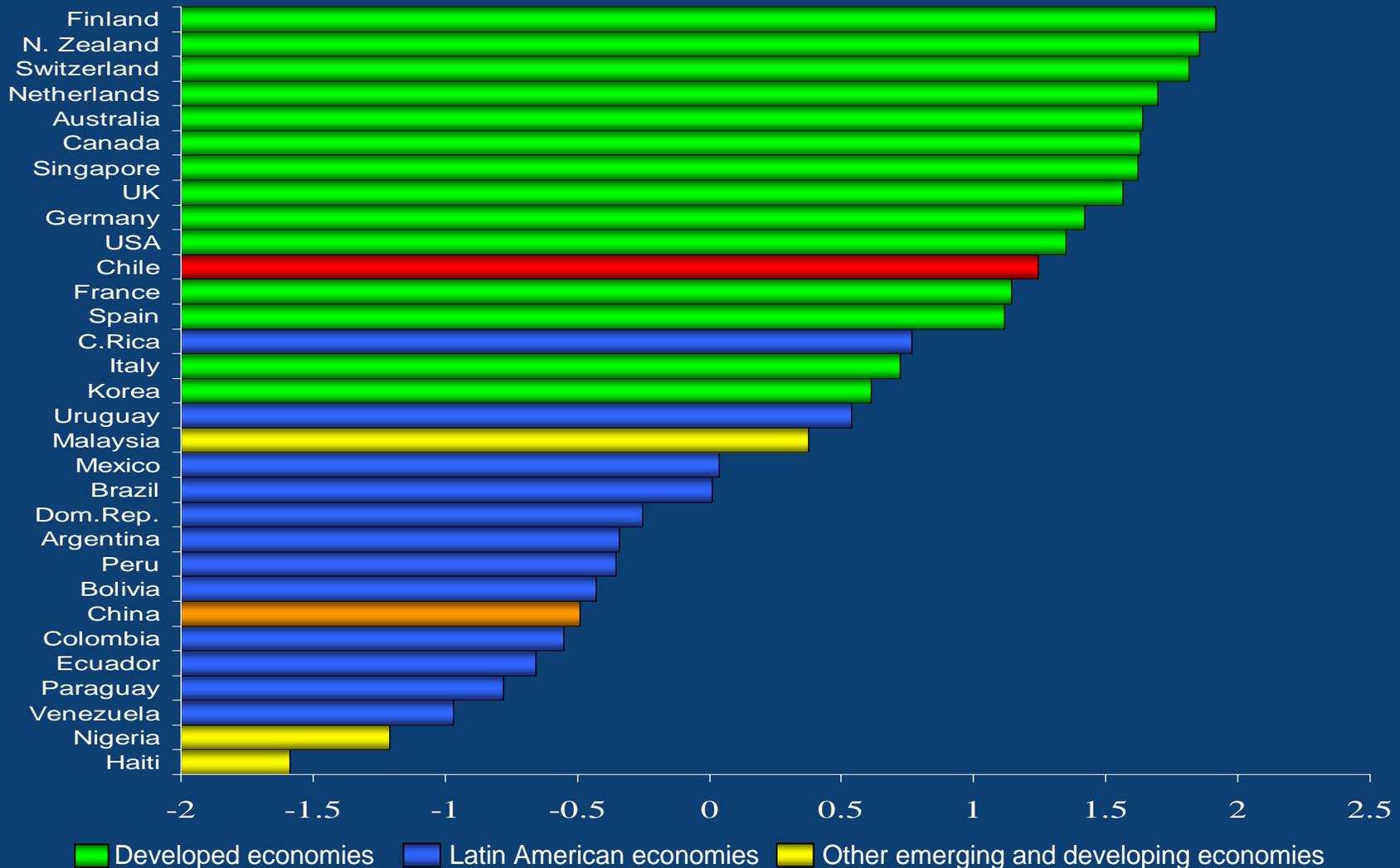
Source: Central Bank of Chile (based on Moody's Financial Strength Ranking).

# 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.

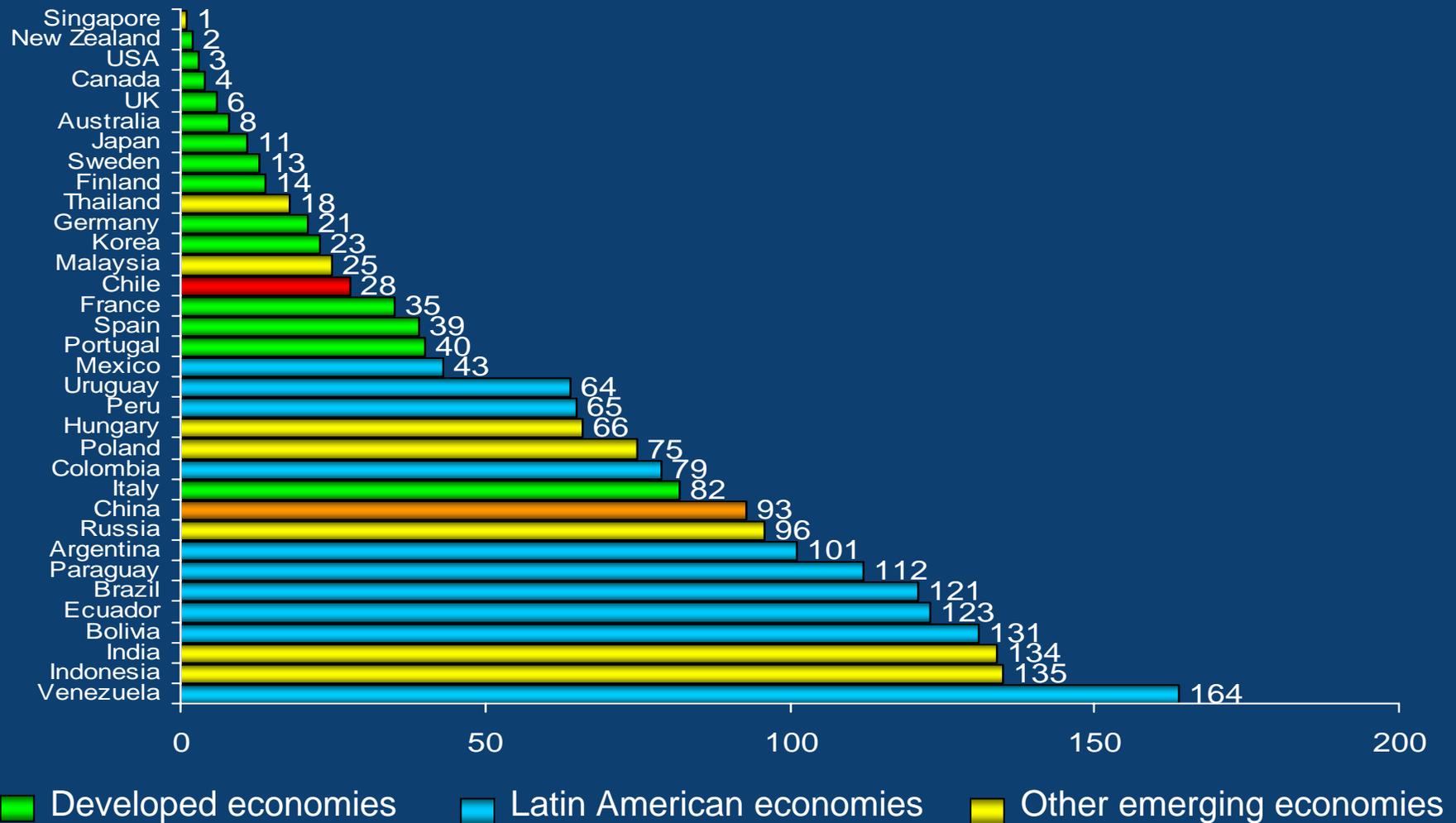
# Quality of Institutions (2004)



Source: World Bank (2005).

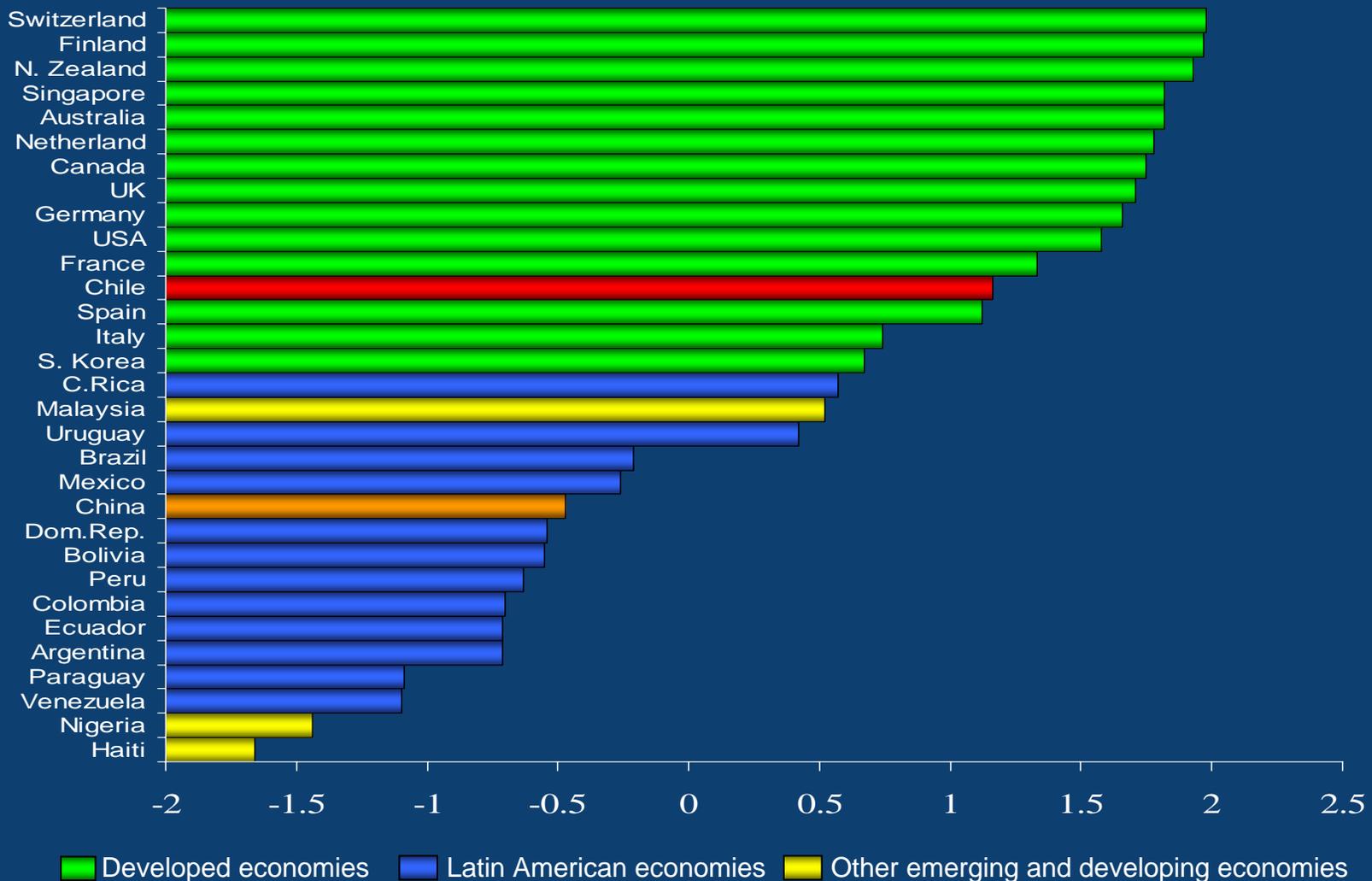
Note: Average of six indexes: rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability.

# 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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