



Fundamentals and Perspectives of the Chilean Economy

Vittorio Corbo
Governor



Outline

1. Introduction
2. Performance of the Chilean economy
3. Perspectives for the Chilean economy
4. Conclusions



1. Introduction



The economy

- Chile has shown outstanding economic performance during the past twenty years.
- Average growth in the last two decades was 5.9% and projections for 2007 range between 5%-6%.
- Inflation has declined steadily, approaching developed-country levels.
- These results have been achieved within an economic model based on macroeconomic stability, strong institutional settings, robust financial sector, competitive open markets and a comprehensive social network.



The foundations of the economy

- The Chilean model has been built with a combination of policy reforms and institutional setting:
 - Fiscal consolidation and monetary discipline;
 - Trade opening and competition policies;
 - Private sector involvement in infrastructure development through BOT concessions;
 - Targeting of governments' spending and subsidies.



2. Performance of the Chilean economy



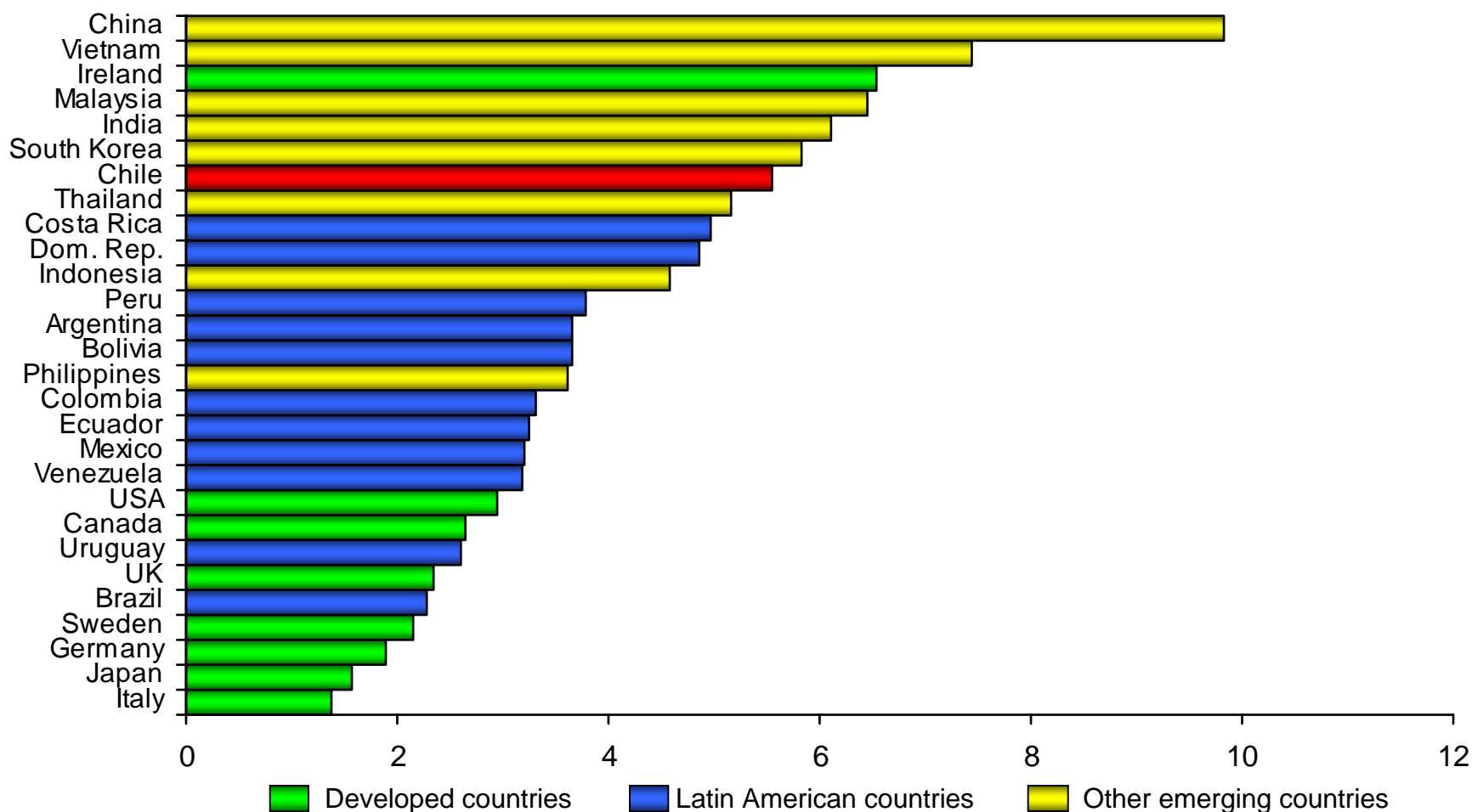
Economic performance

- With the reforms, Chile acquired solid macro fundamentals together with modern and robust institutions, all necessary elements for attaining high and sustainable growth rates:
 - High growth rates due mainly to efficiency gains;
 - Reduced per capita income gap with developed countries;
 - Highly competitive economy;
 - Low country risk;
 - Substantially improved social indicators.



Economic growth 1990-2006

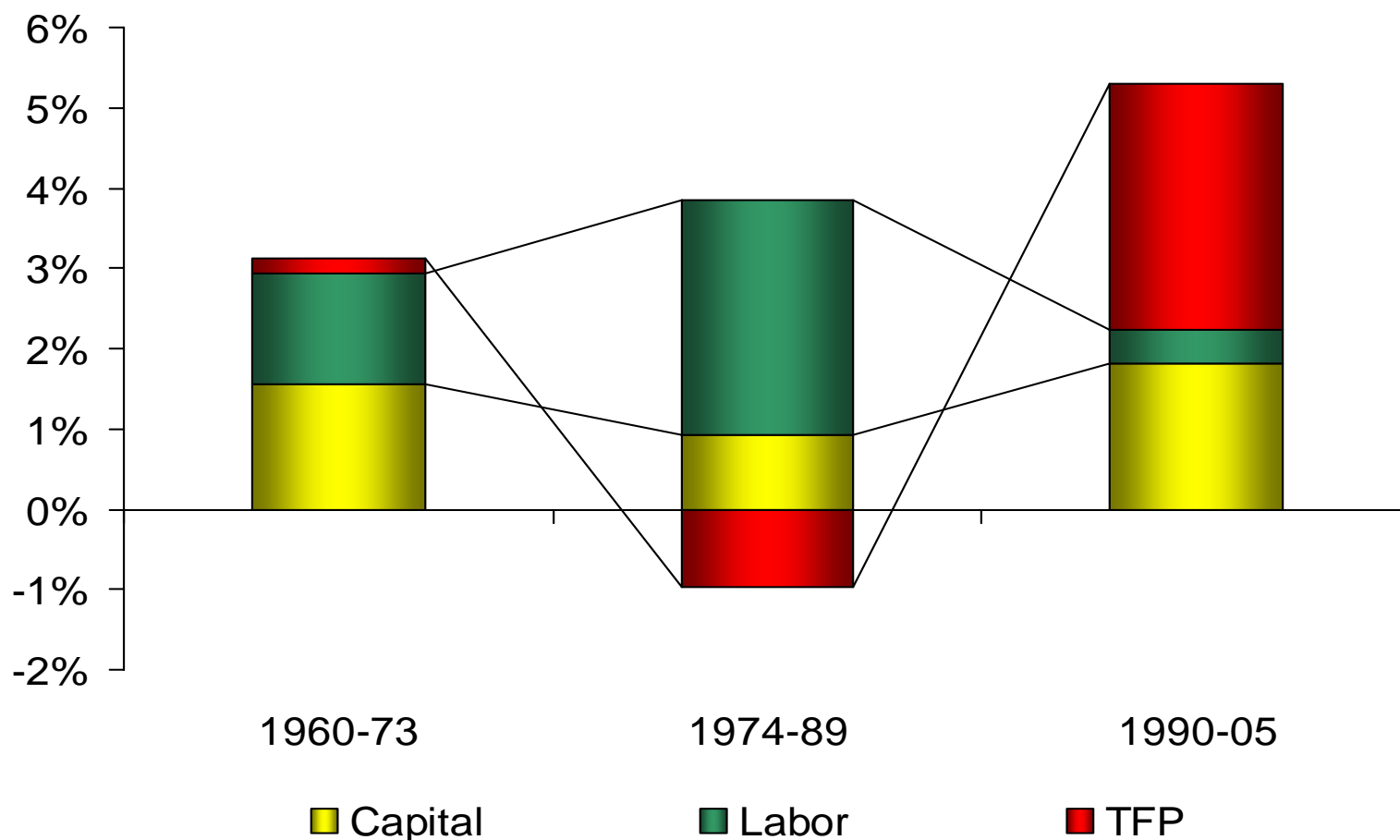
(yearly average, %)



Note: For Argentina, Colombia, Ecuador, India, Ireland, Peru, UK and Vietnam GDP growth for 2006 is taken from IMF estimations.
Source: World Economic Outlook (April 2007), *IMF*.



Solow's decomposition of economic growth: Chile

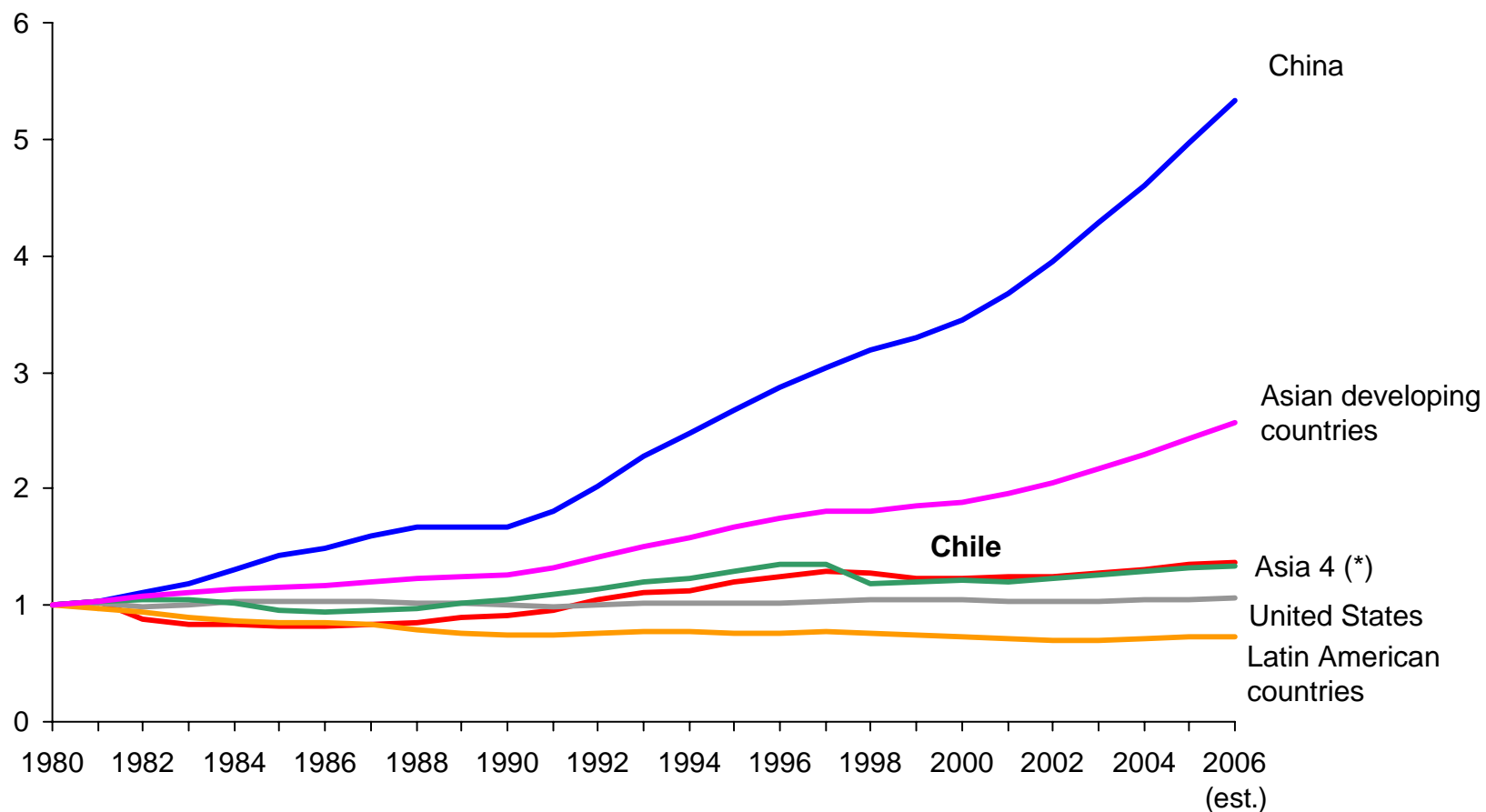


Source: Fuentes, Larraín and Schmidt Hebbel (2004).



Relative per capita output

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



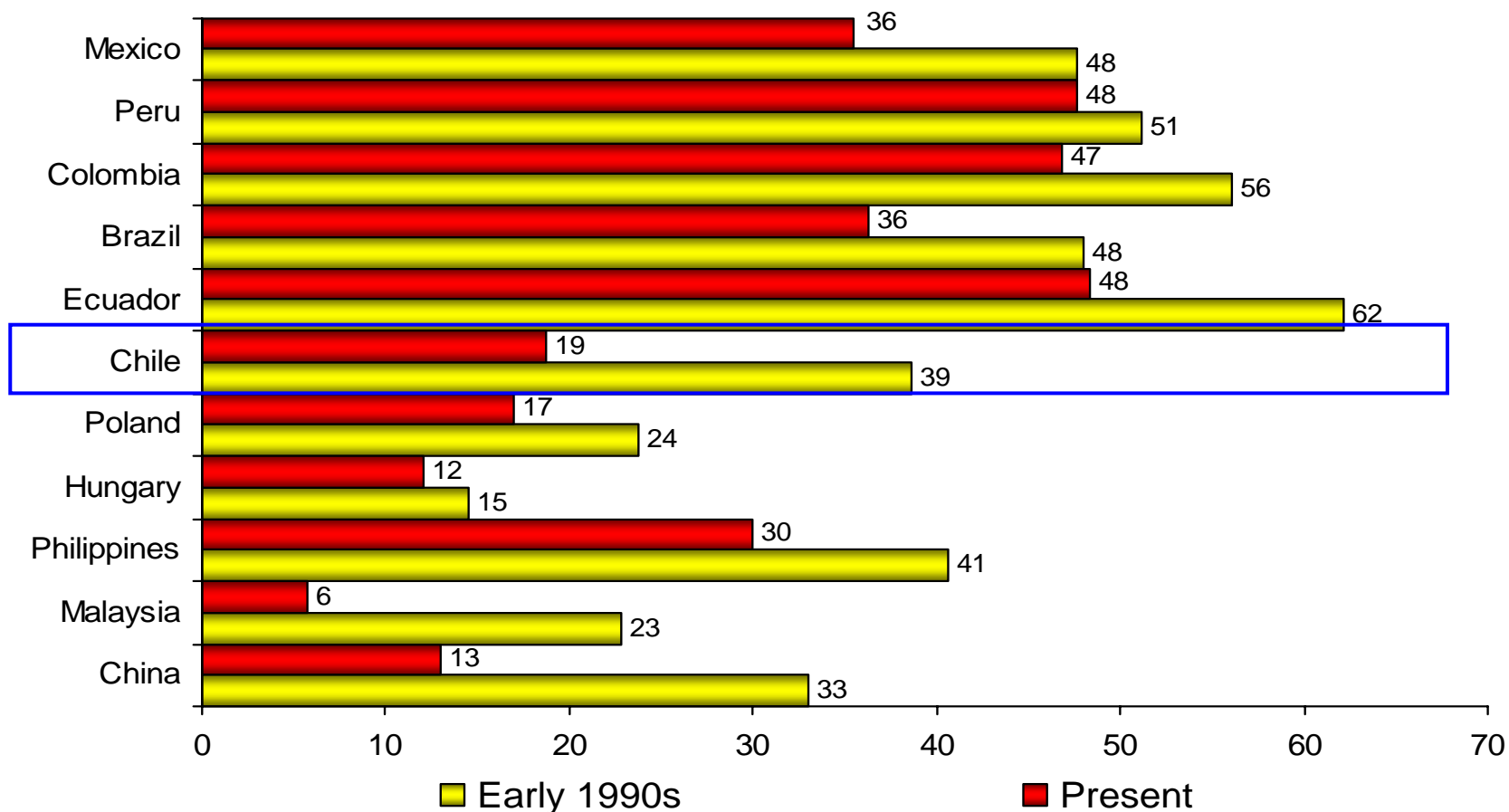
(*) Asian 4: Malaysia, Indonesia, Thailand and Philippines.

Source: Own calculations, based on World Economic Outlook (April 2007), IMF.



Poverty rate

(%, population below poverty line)

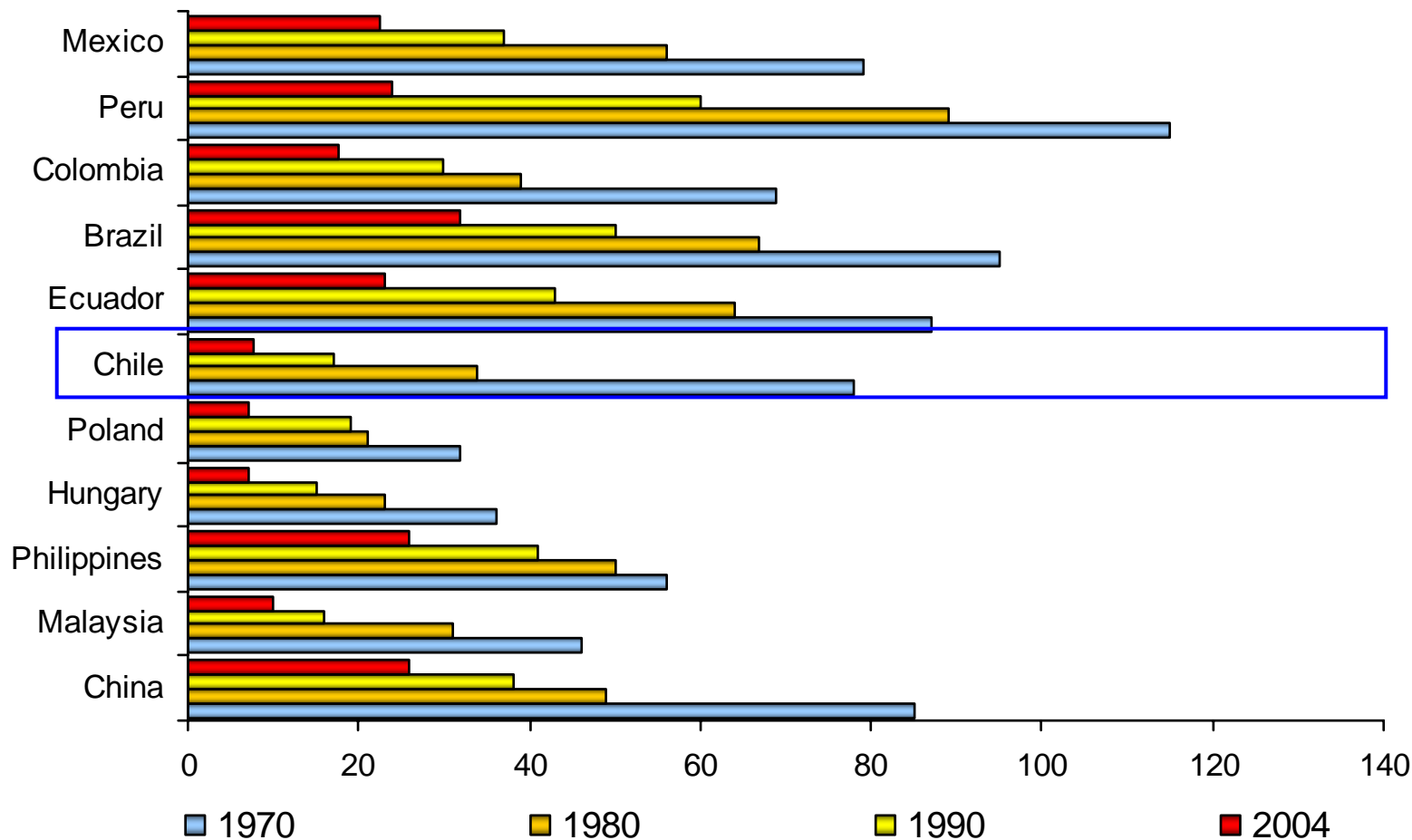


Note: Present stands for 2005 in Mexico, Colombia, Brazil and Ecuador; for 2004 in Malaysia and Peru; for 2003 in Chile, Poland, Hungary, China and Philippines.

Sources: ECLAC (2006), MIDEPLAN (2005), Asia Development Bank and Eurostat.



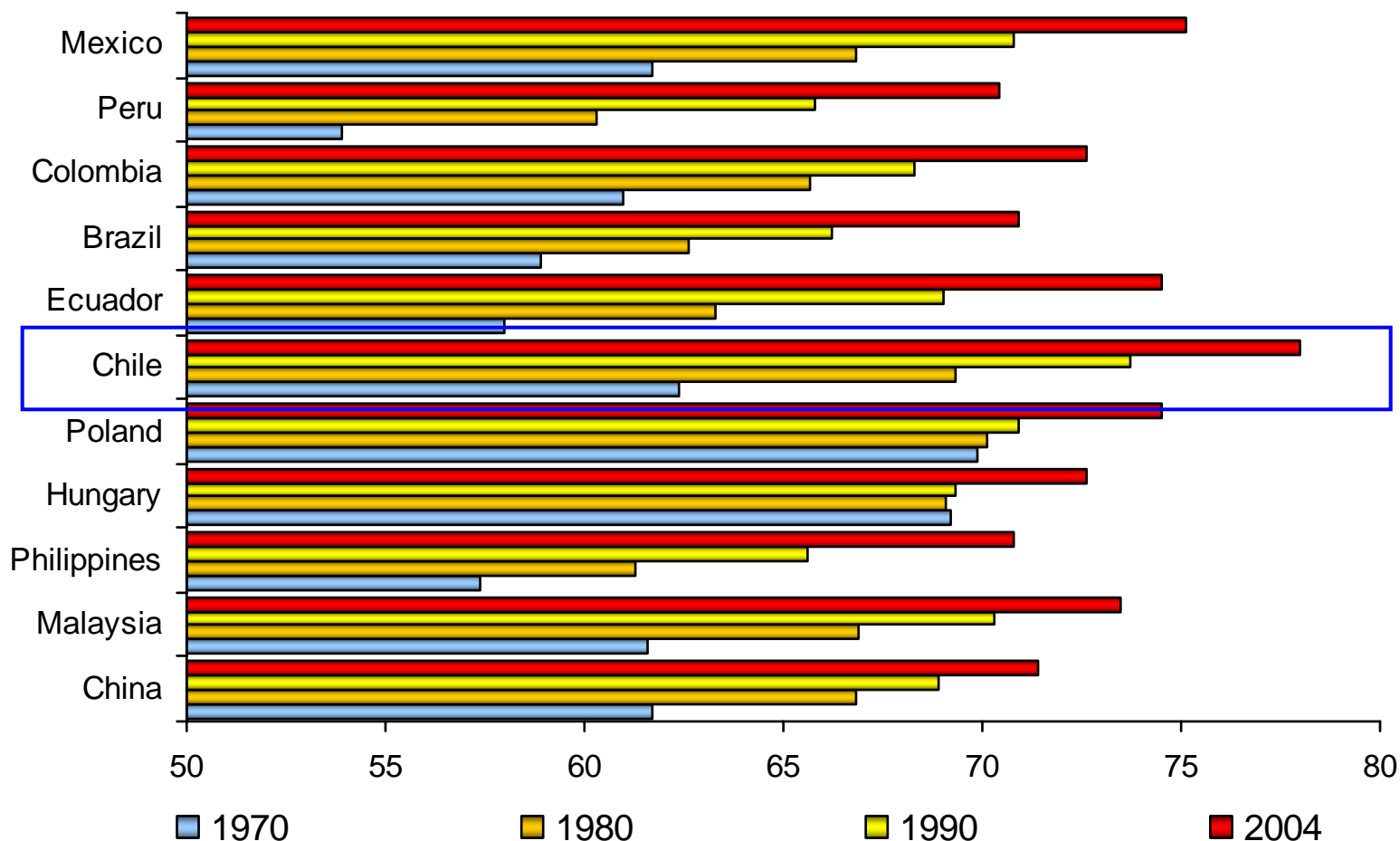
Infant mortality (per 1000 live births)



Source: World Development Indicators 2006, *World Bank*.



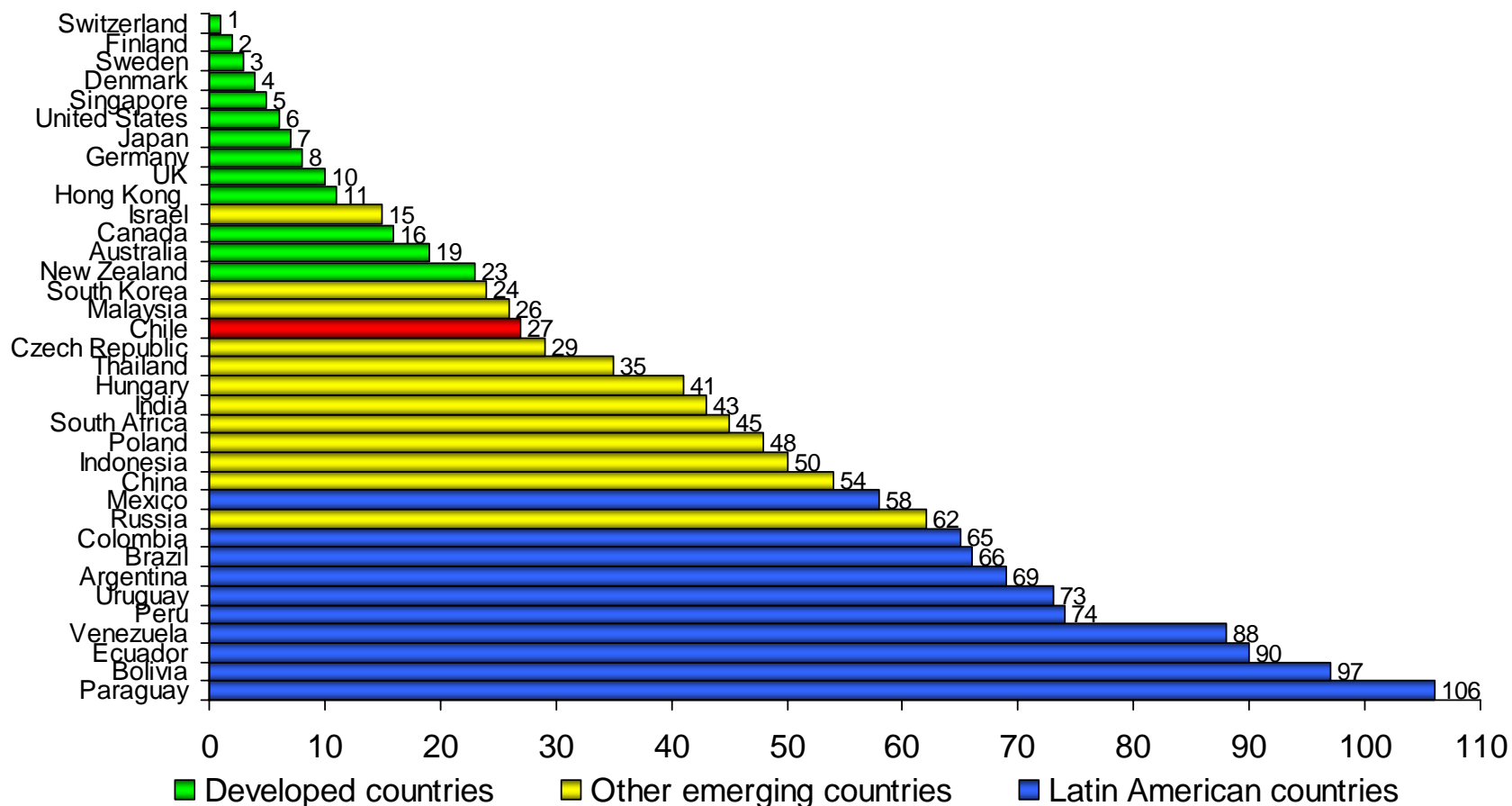
Life expectancy at birth (total years)



Source: World Development Indicators 2006, *World Bank*.



Competitiveness (ranking, 2006)

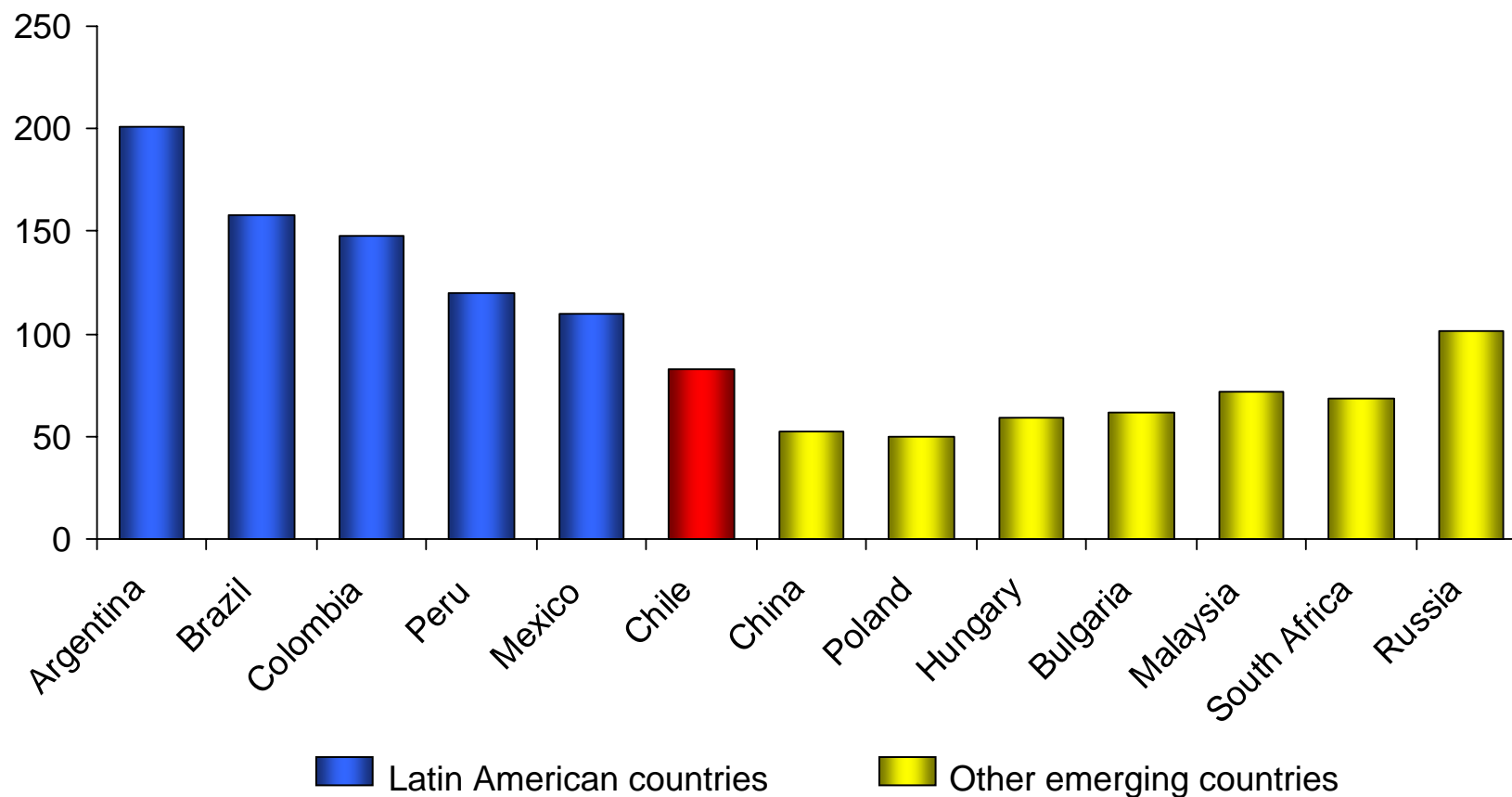


Note: The competitiveness index measures country's ability to achieve high and sustainable per capita GDP growth. The number beside each bar represents the place in the ranking.

Source: *World Economic Forum* (September 2006).



Country risk (basis points)



Note: As of April 10, 2007.

Source: JP Morgan Chase.

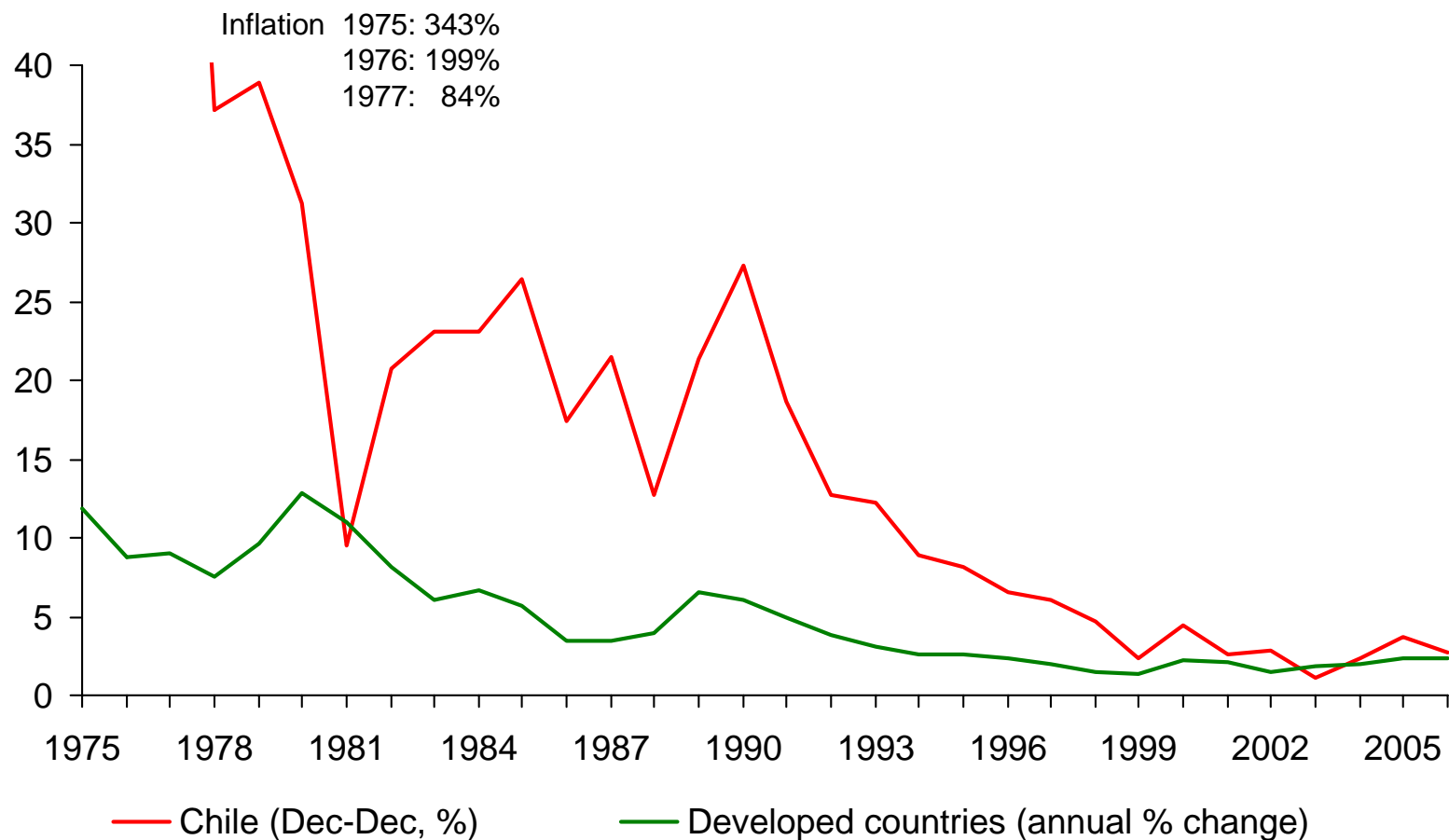


Successful monetary policy

- Gradual decline in inflation and inflation volatility, approaching industrial-country levels, and successfully achieving the 3% inflation target.
- Among IT-countries, Chile has a good record of reaching the inflation target.
- Overall, monetary policy has contributed to macroeconomic stability.



Inflation rate (1975-2006)

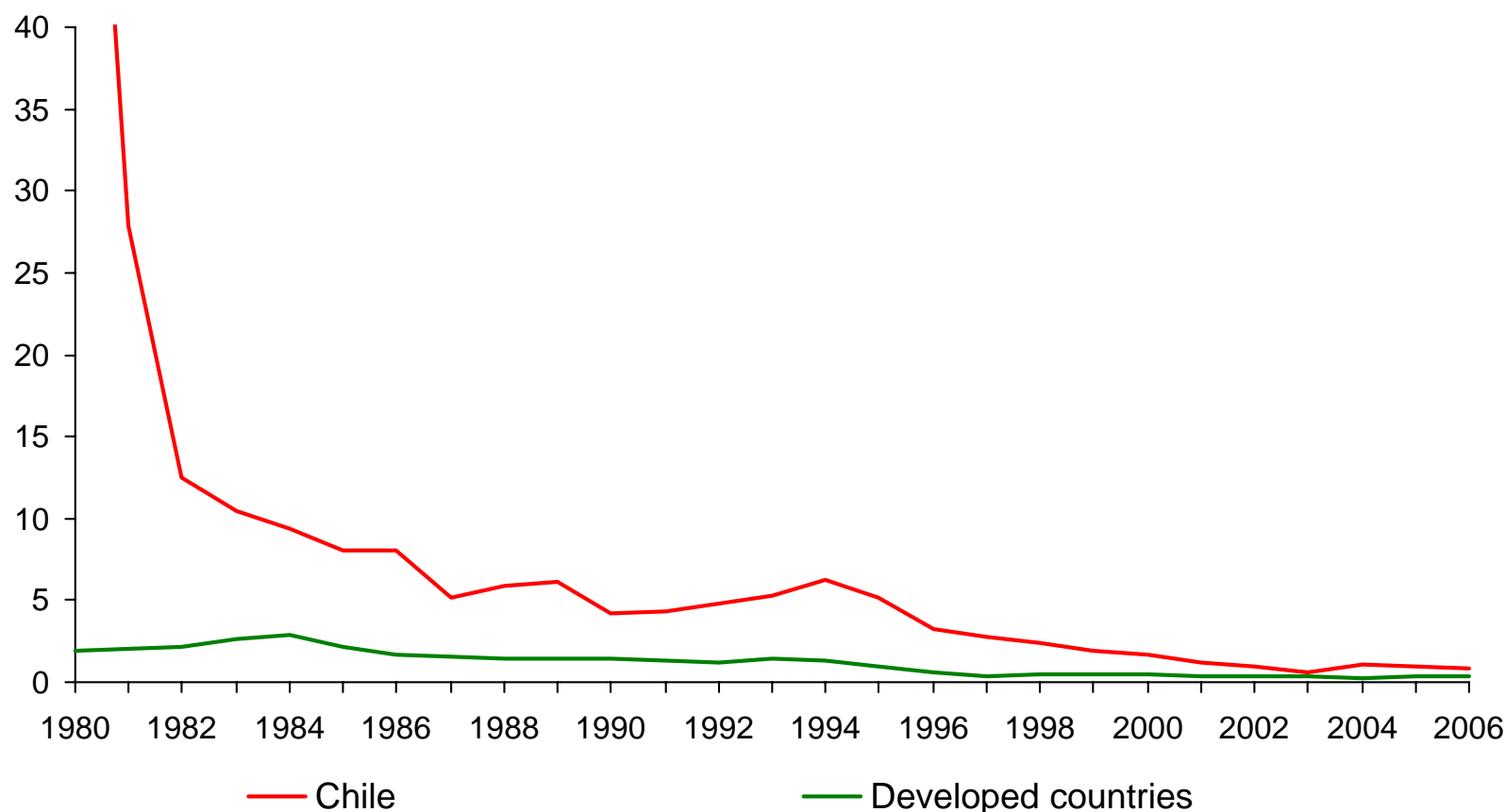


Sources: Central Bank of Chile and World Economic Outlook (April 2007), *IMF*.



Inflation volatility

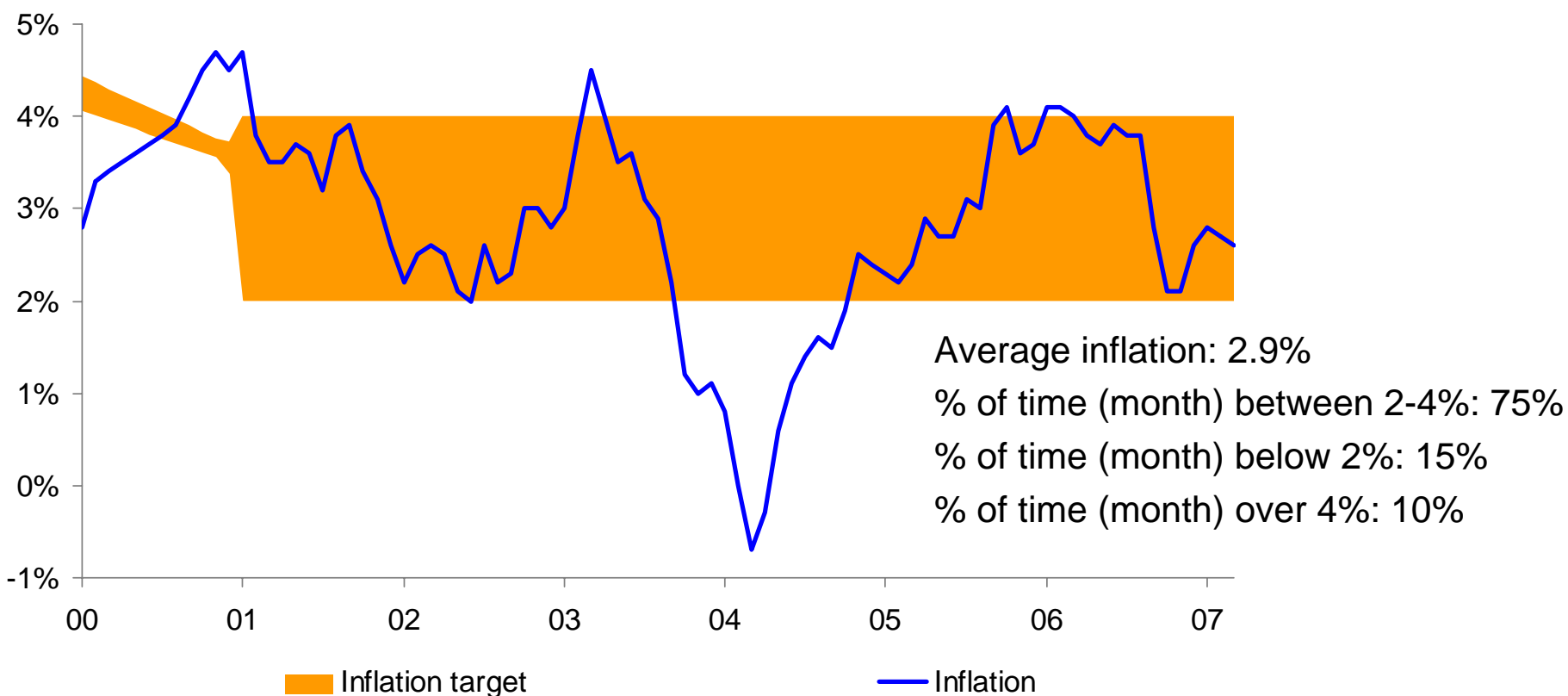
(standard deviation of rolling five-year window)



Sources: Central Bank of Chile and World Economic Outlook (April 2007), *IMF*.



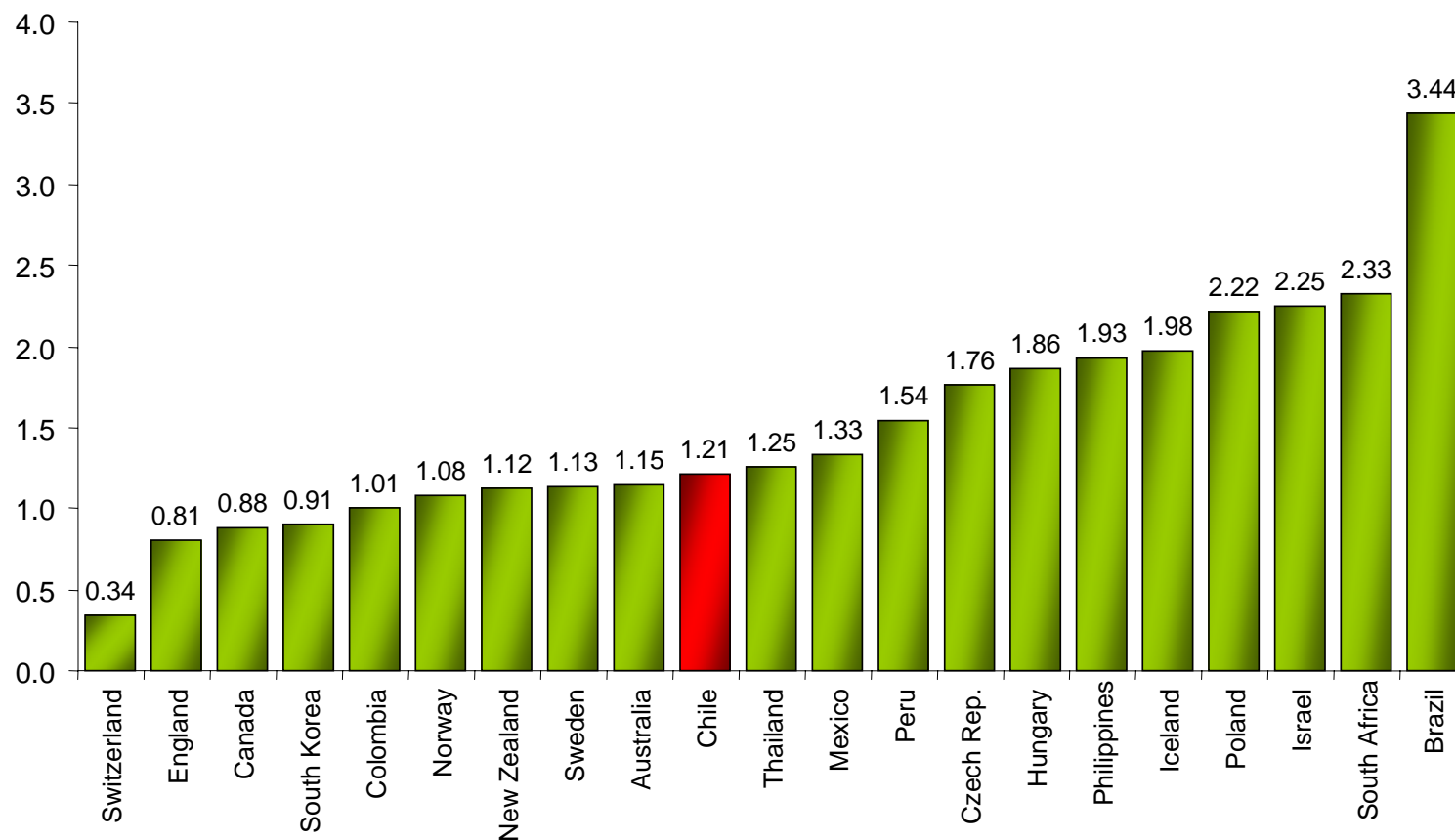
Deviation of inflation rate from target (January 2000- March 2007, annual percent change)



Source: Central Bank of Chile.



Absolute deviation of inflation from target



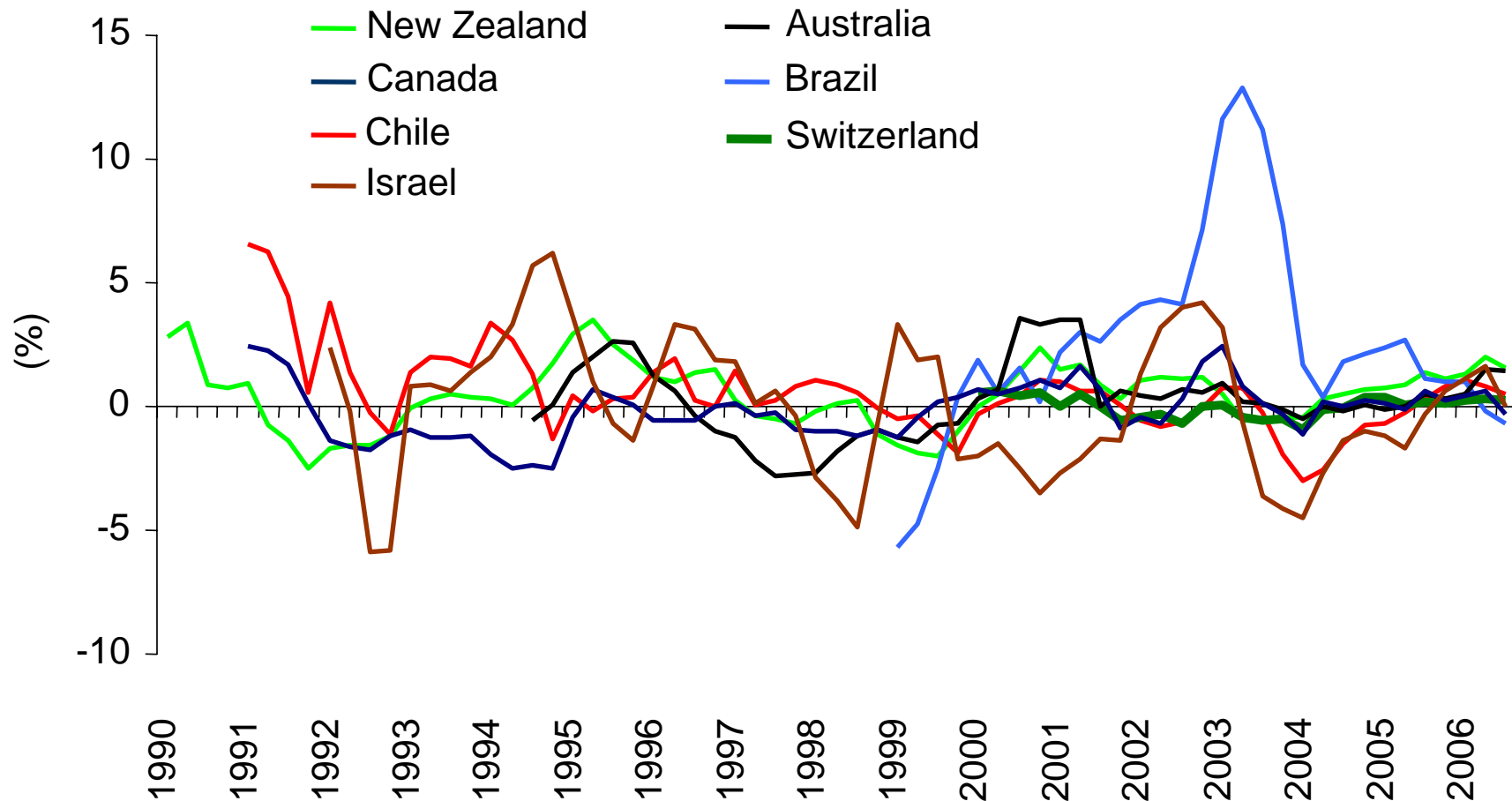
Note: Considers the starting period of an inflation-targeting scheme to September 2006.

The initial period of an inflation-targeting scheme varies across countries.

Source: Based on Albagli and Schmidt-Hebbel (2005).

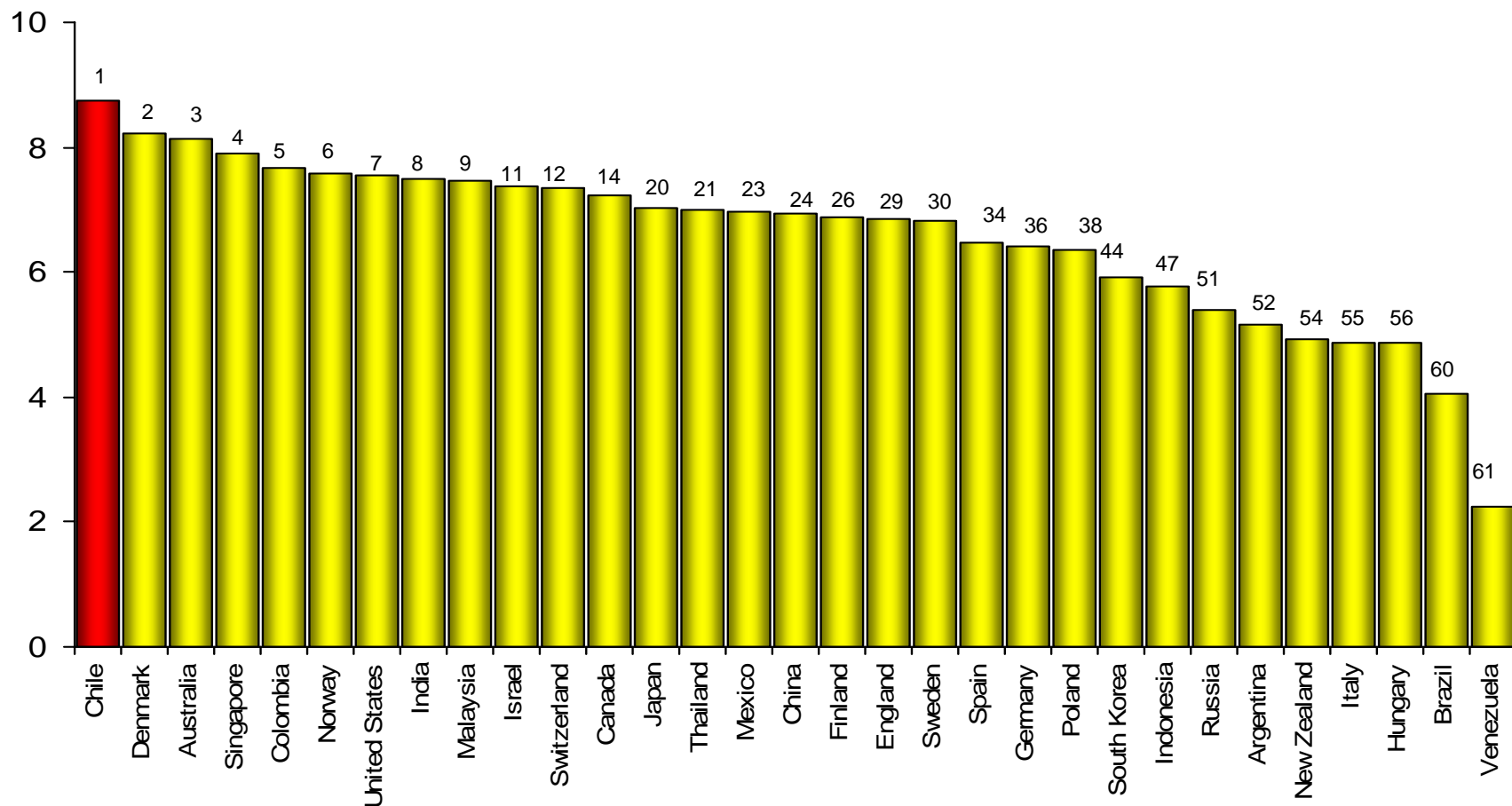


Deviations of inflation from target





Contribution of monetary policy to macroeconomic performance (ranking, 2006)



Note: It is quantified in a scale from 1 to 9. The number over each bar represents the place in the ranking.

Source: *Institute for Management Development* (2006).

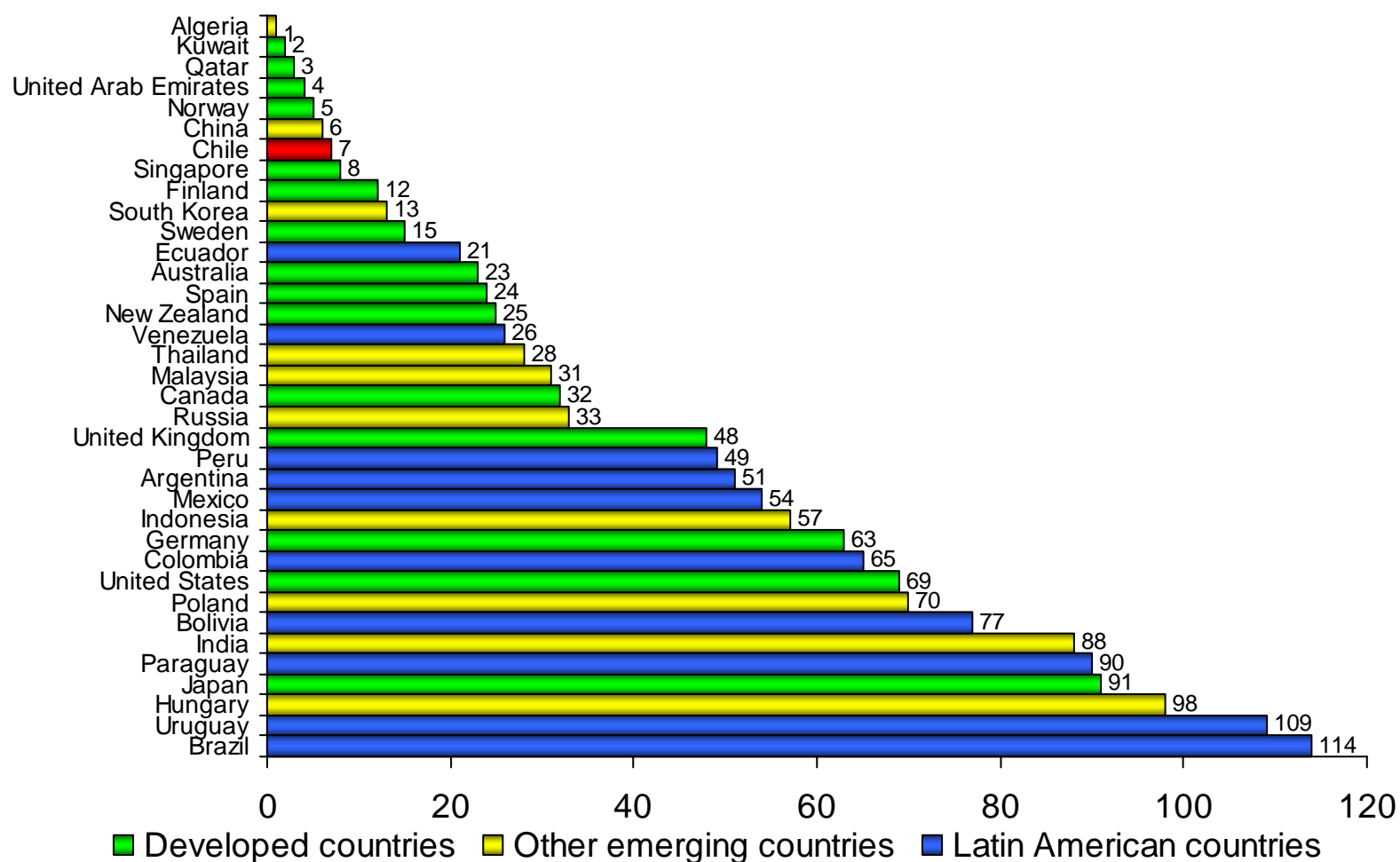


Main strengths

- As a result of all the above, Chile is today better prepared than in the past (and compared to other emerging economies) to accommodate shocks.
- Chile's main strengths include:
 - Proven macroeconomic framework;
 - Solid fiscal situation and very low public debt (a negative consolidated net public sector debt);
 - Robust financial system;
 - Strong institutions (e.g., rule of law, independent central bank).



Macroeconomic management (ranking, 2006)



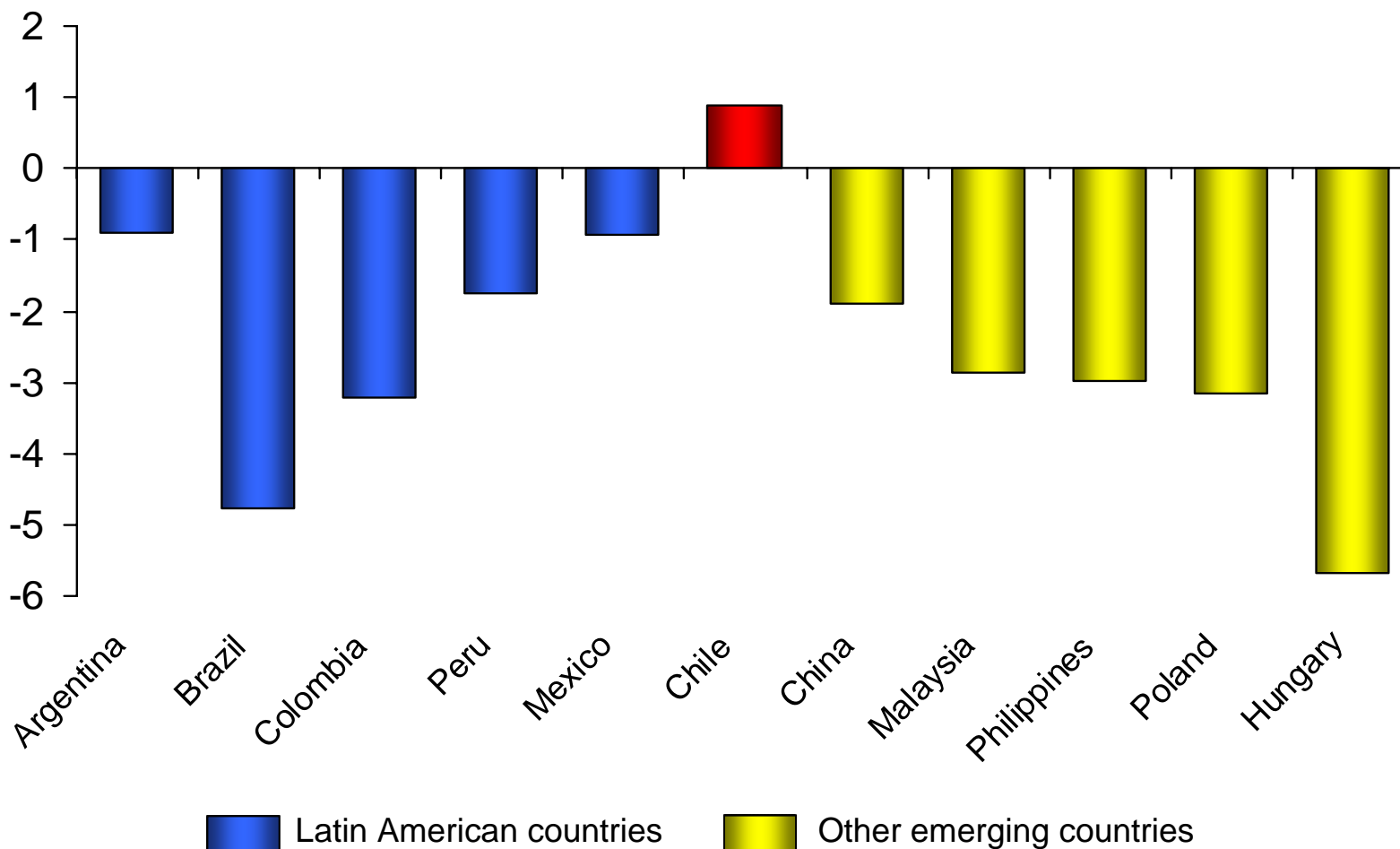
Note: The number beside each bar represents the place in the ranking.

Source: *World Economic Forum* (September 2006).



Fiscal balance

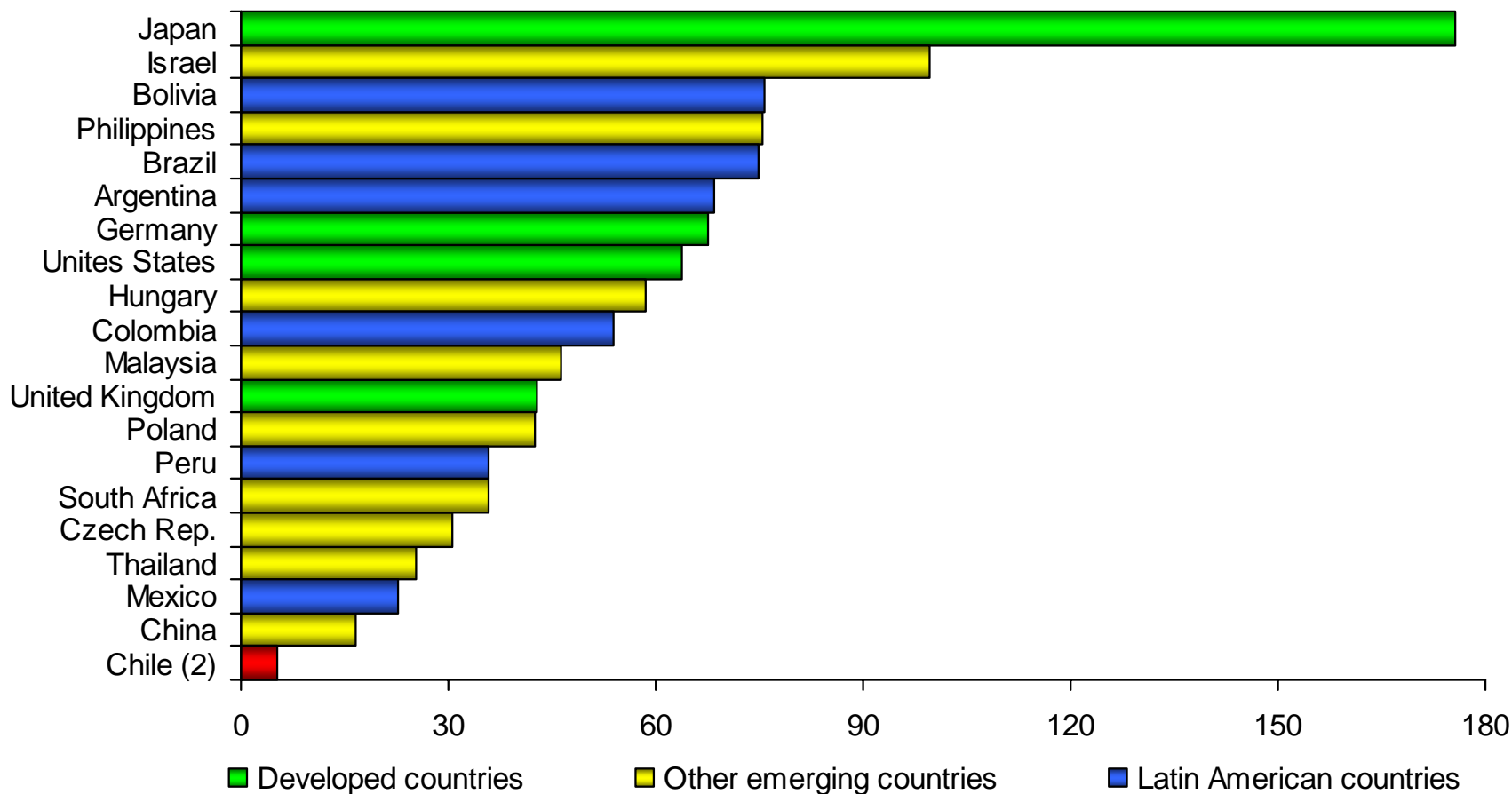
(% GDP, average 1995-2005)



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



Public debt (1) (% GDP, 2005)

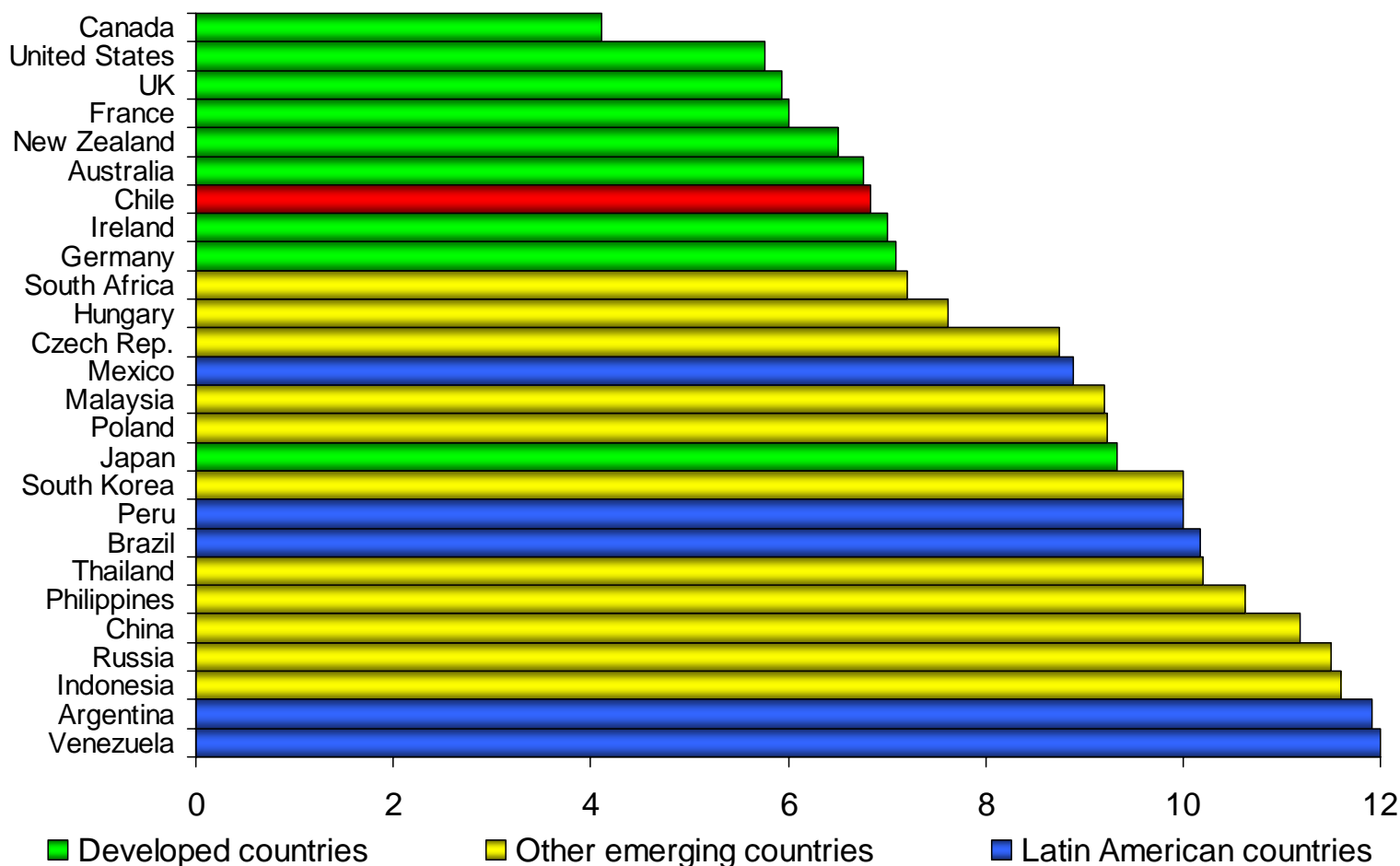


(1) General government debt.(2) As of December 2006 (Preliminary).

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



Banking system strength (index, 2006)

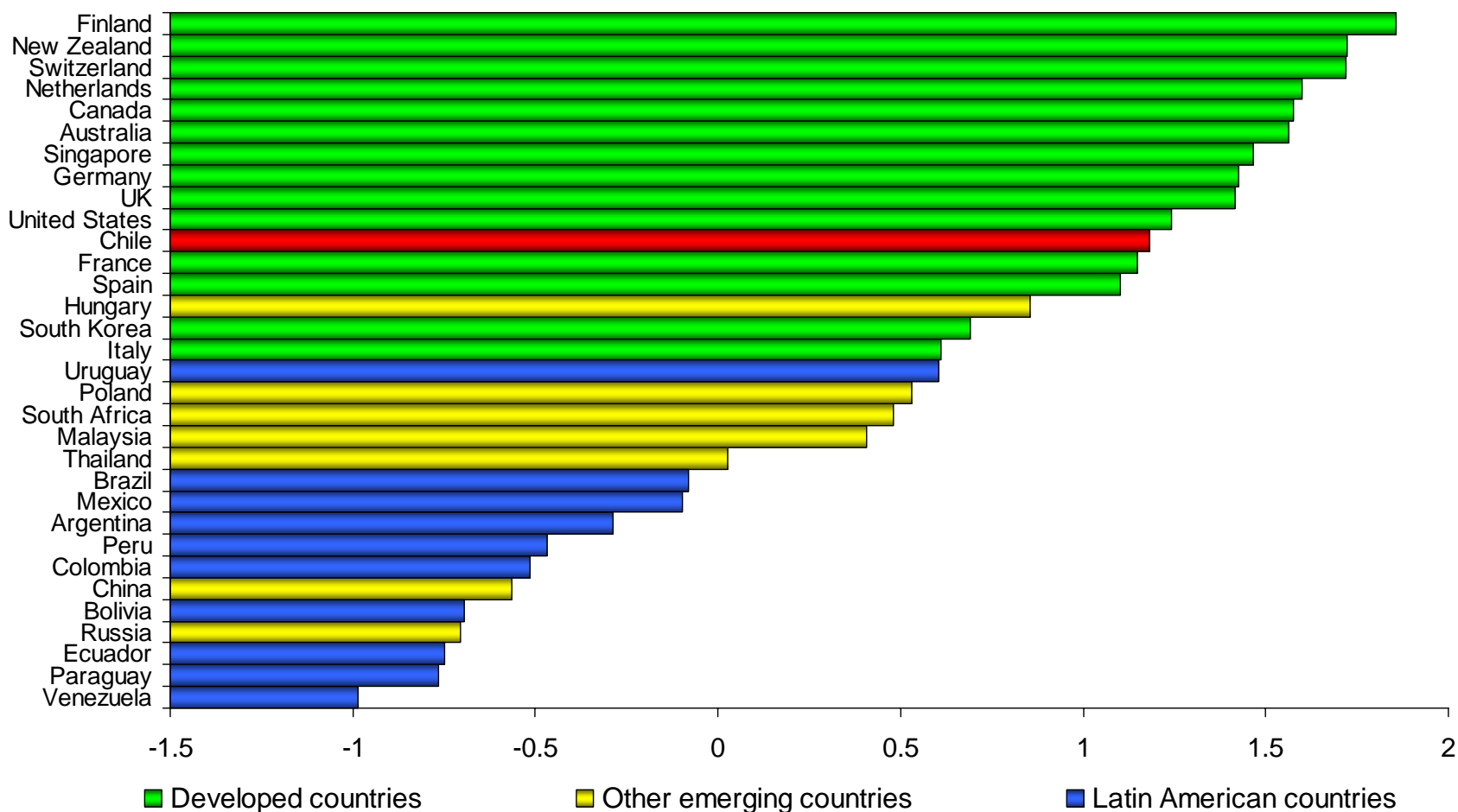


Note: It is quantified in a scale from 1 to 13.

Source: Central Bank of Chile, based on *Moody's Financial Strength Ranking* (December 2006).



Quality of institutions (index, 2005)



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

Source: *World Bank* (September 2006).



3. Perspectives for the Chilean economy



Economic development in 2006

- GDP grew 4% in 2006 (at constant prices of 2003), below early year projections and at odds with the favorable macroeconomic conditions.
 - Weakness in some sectors (fisheries, mining and industry), widened the capacity gap, and reduced inflationary pressures during the second half of 2006.
- Domestic demand:
 - Mainly driven by investment in machinery & equipment, growing strongly in the first half of 2006, but decelerating in the second half.
 - Private consumption has grown at a steady rate, sustained by employment and wages and good financial conditions, despite increase in oil prices during August 2006.
 - Non-mining exports have also been dynamic, sustained by favorable world economic growth and international prices.



GDP expenditure at constant prices of 2003

(change semester to semester of each year, %)

	Internal demand	Private demand	Government consumption	Gross fixed capital formation	Construction	Machinery & equipment	Exports of goods and services	Imports of goods and services
1S2004	4.9	6.7	5.8	3.2	-2.2	13.7	9.8	11.9
2S2004	10.0	7.2	6.2	16.6	8.2	33.1	13.8	21.6
1S2005	13.0	8.4	6.1	25.3	16.3	39.9	4.0	20.9
2S2005	9.1	7.5	4.5	18.9	7.1	37.7	3.0	14.9
1S2006	7.0	7.6	3.7	5.6	4.1	7.6	4.2	10.7
2S2006	5.1	6.7	3.5	2.6	3.6	1.4	4.2	8.3

Source: Central Bank of Chile.



First quarter of 2007

- Private consumption remains robust.
- Investment recovery initiated in the fourth quarter of 2006 continues, supported by good business profits and favorable internal financial conditions.
- Exports of non-mining sector continue growing at high rates.
- Labor market remains strong:
 - Employment continues growing fast, especially the wage-earning segment;
 - Unemployment rate has stabilized, after sharp decline in the past few years.
- Latest international financial market instability (Feb.-Mar. 2007) had an impact on domestic markets, however smaller than in other EM and other instability episodes (May 2006).



Total profit value (*) (annual moving average, %)

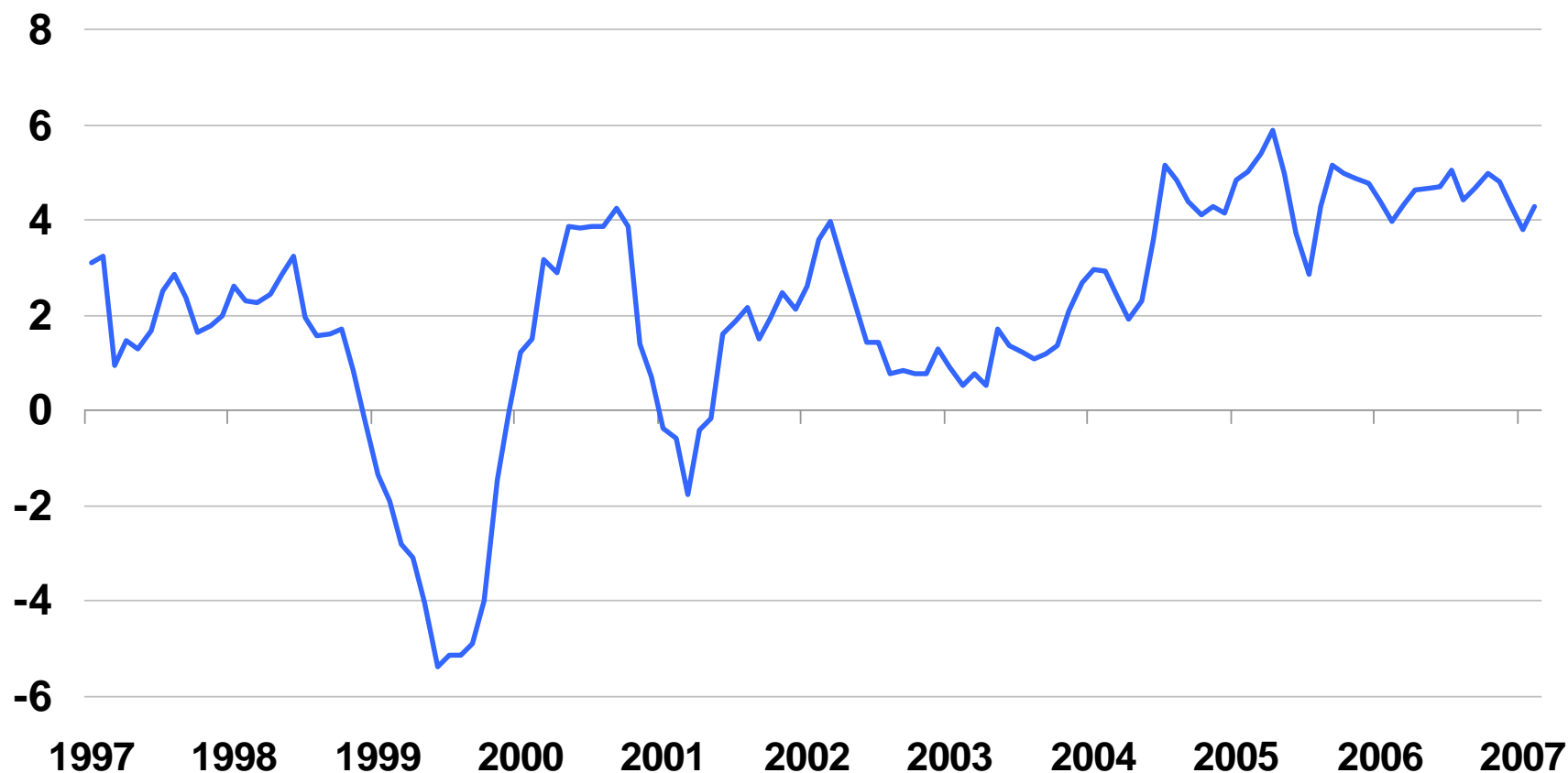


(*) Earnings for the period over equity.

Source: Central Bank of Chile and Superintendence of Securities and Insurance.



Salaried employment (annual change, %)

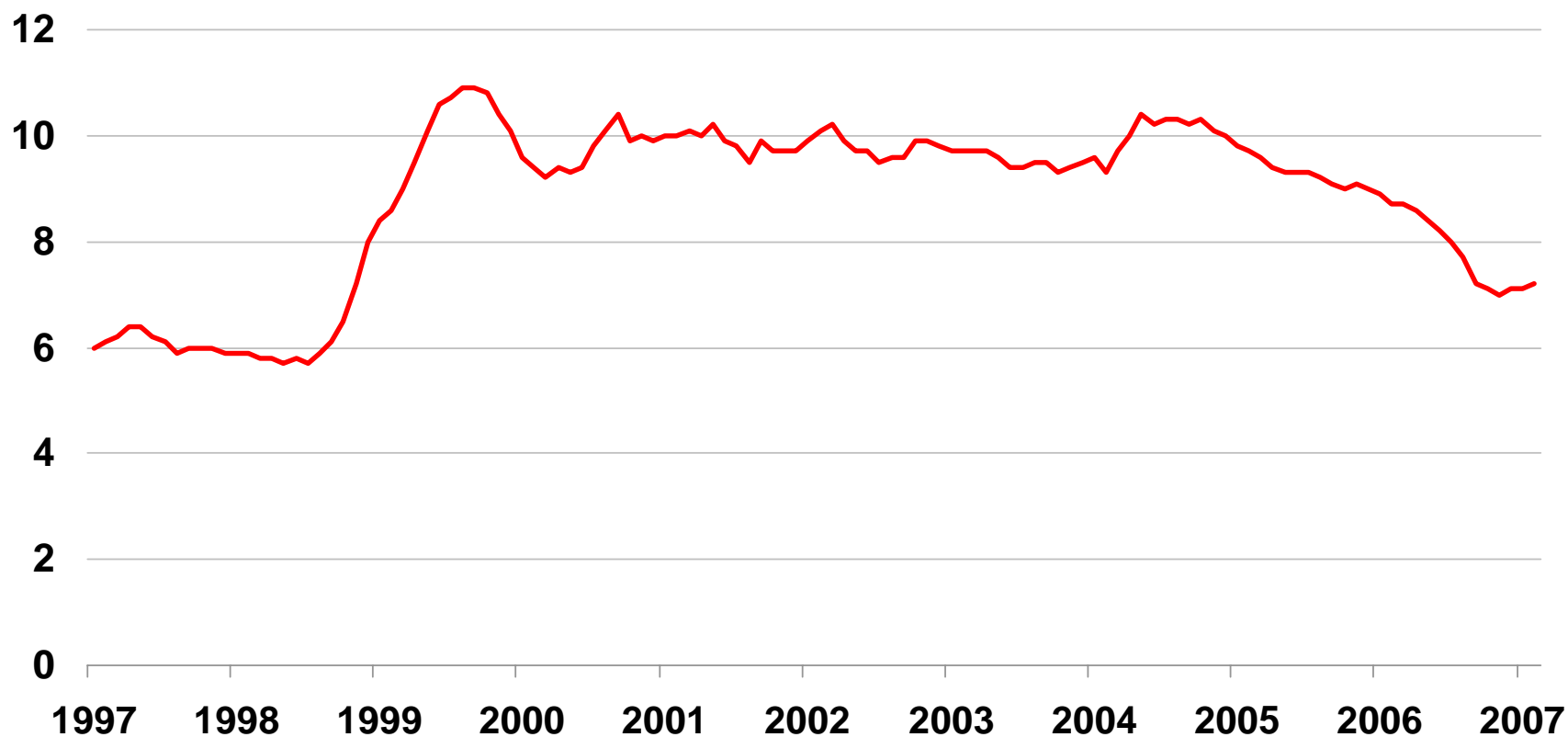


Source: National Statistics Bureau.



Unemployment rate

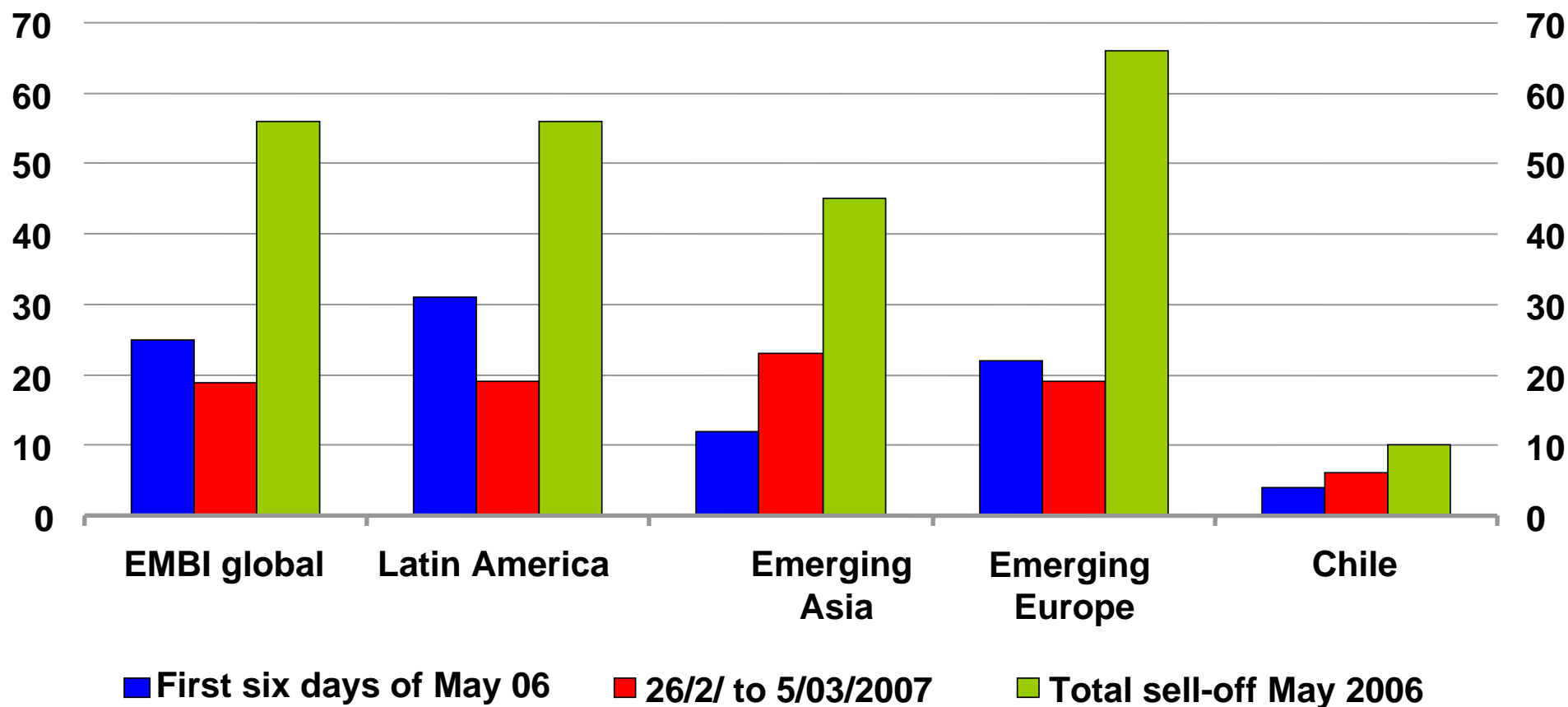
(percent, seasonally adjusted)



Source: National Statistics Bureau.



Sell-off episode comparison: Spread movements (basis points)



Sources: Bloomberg and JP Morgan Chase.



Evolution of financial indicators

(change between 26 February and 5 March)

	Currency (local currency /USD)	Stock markets (local currency)	Government bond (nominal to 10 years, bp)
Germany	0,7%	-7,0%	-8,0
Australia	3,0%	-6,5%	-17,7
Brazil	2,6%	-10,9%	53,4
Chile	1,0%	-2,5%	-7,0
United States		-4,6%	-13,0
Hungary	1,5%	-6,0%	7,0
Israel	0,8%	-3,6%	-6,9
Japan	-4,2%	-8,6%	-3,6
Mexico	1,0%	-8,1%	-6,9
New Zealand	5,2%	-1,8%	-11,9
United Kingdom	2,2%	-5,8%	-8,7
South Africa	5,9%	-7,7%	20,5
Turkey	5,1%	-9,2%	74,9

Source: Bloomberg.



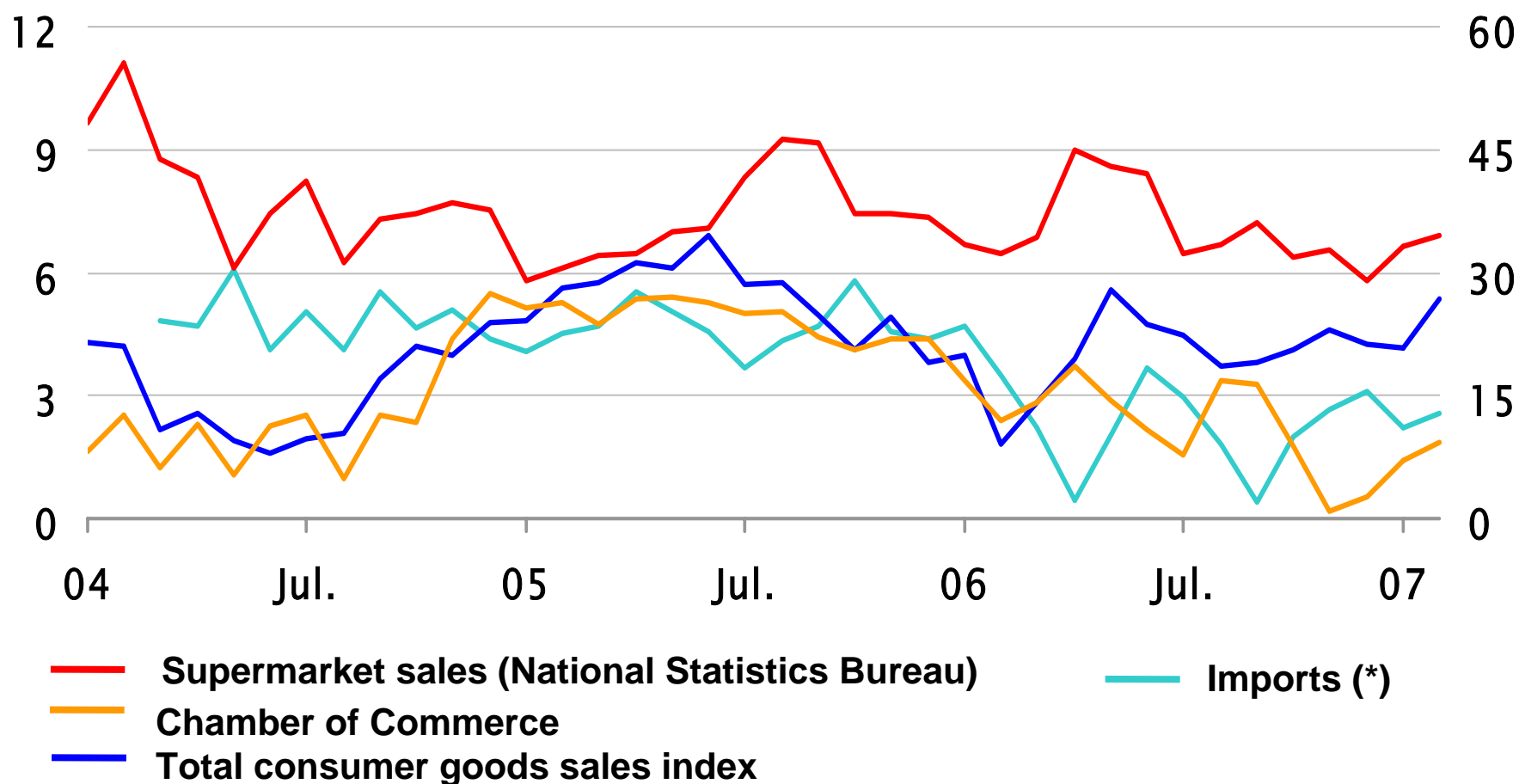
Perspectives 2007

- For 2007, activity is projected to grow between 5% and 6%, under the baseline scenario, due to:
 - Increased investment;
 - No further change in origin of non-durable consumption;
 - Lower expected increase in energy prices;
 - Stronger fiscal impulse.
- The baseline scenario for inflation contemplates that over the policy horizon, defined at around two years, headline and core inflation come to 3%. Down the line, it should be around 2% over part of 2007.



Non-durable consumption: indicators

(Moving quarterly average of annual change, %)

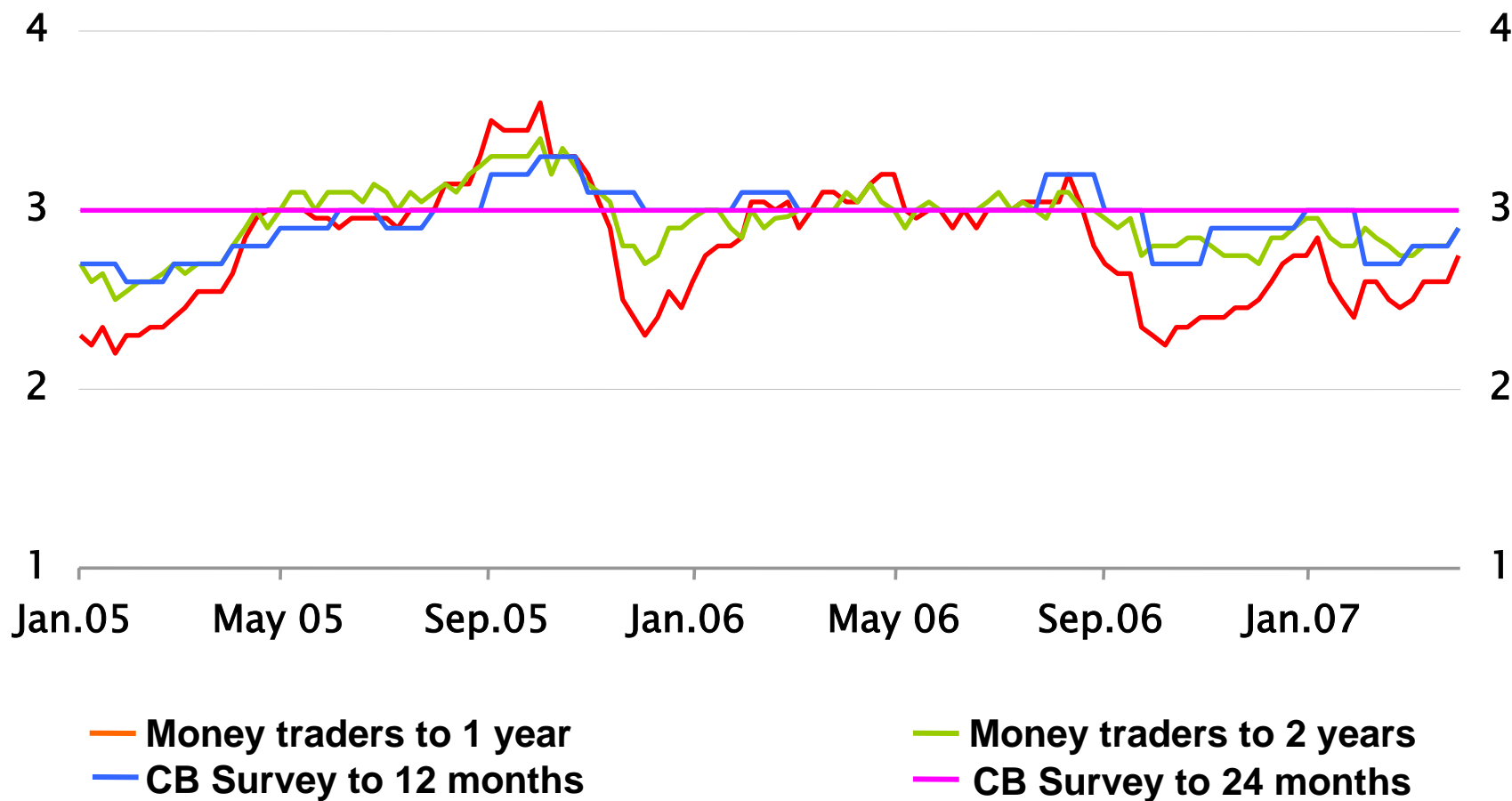


(*) Nominal.

Source: Central Bank of Chile, Chamber of Commerce and National Statistics Bureau.



Expected inflation (weekly observation, %)



Source: Central Bank of Chile.



Perspectives 2007

- Projections are build on a baseline scenario that faces risks.
- External risks include:
 - Larger than expected deceleration of US growth, due to correction in housing markets.
 - Pronounced reduction of risk appetite by international investors as a consequence of a crisis in an emerging country, or an important financial institution or geopolitical problems.
 - Greater inflationary pressures in industrial countries, plus China and India, associated to progressive reductions in excess capacity.



Perspectives 2007

- On the domestic side, risks include:
 - The economy growing at a faster-than-expected rate, with greater impulse of consumption.
 - Smaller capacity gap than previously estimated.



4. Conclusions



Conclusions

- The new economic model built over the last three decades is the main rationale for Chile's outstanding economic performance of the past twenty years.
- Chile's experience shows that there are some key elements in achieving sustainable economic growth:
 - Macroeconomic stability with autonomous central bank and solvent fiscal sector;
 - Sound financial sector, with dynamic and competitive banks, highly capitalized and appropriately supervised and regulated;
 - Competitive open-market economy;
 - Comprehensive social network.



Conclusions

- The solid macro fundamentals and robust institutions, together with the good prospects for the world economy, allow us to look at the future with optimism.
- For 2007, GDP growth is projected to be between 5%-6%, and inflation to approach the 3% target over the policy horizon of around two years.



The Chilean economy: Institutional buildup and perspectives

Vittorio Corbo
Governor