



# The Chilean economy: Institutional buildup and perspectives

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# Outline

1. Introduction
2. Chile's economic reforms and institutional buildup
3. Performance of the Chilean economy
4. Conclusions



# 1. Introduction



# Introduction

- 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.



## 2. Chile's economic reforms and institutional buildup



# Period up to the 1970s

- In the early 1970s, 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.



# The 1970s

- In the 1970s, 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 a flat 10% in 1979;
  - Privatization: State-owned enterprises and banks were privatized or returned to previous owners.



# 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 removed.
- In 1981, Chile carried out a major reform to the social security system.





# 1982-83 crisis

- Stabilizing and market-oriented policies allowed quick growth. However, some weaknesses emerged.
- 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 unleash a profound macroeconomic and financial crisis.



# Reforms

- The 1982-83 crisis uncovered major regulatory shortcomings and triggered in 1986 a revision of several institutions. In particular, second-generation reforms included:
  - 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 thriving market economy model.
- Since then, additional weight has been given to social policies as a way to build social cohesion and accelerating poverty alleviation.



# The 1990s

- In the 1990s, the reform process continued:
  - Private sector involved in infrastructure development through BOT concessions (1991-92);
  - Competition in telecommunications (multi-carrier system, 1994);
  - Deeper integration into the world economy through unilateral tariff reductions (1991 and 1998) and FTAs: Canada (1996), Mexico (1998) and Central America (1999).
  - Anti-trust rules (1994);
  - Upgrading of banking regulation (1997);
  - Gradual adoption of inflation-targeting regime (1991-99);
  - Abolition of the exchange rate band (1999).



# In the recent years

- Chile has continued strengthening its macroeconomic and institutional framework:
  - Structural fiscal surplus equivalent to 1% of GDP was adopted by a fiscal rule (2001);
  - All capital controls were abolished, completing the opening of the capital account (2001);
  - Capital market reform (2001);
  - FTAs continued and were signed with major trade partners: European Union (2002), EFTA (2003), United States (2003), South Korea (2003), China (2005) and P4 (2005);
  - Competition Tribunals were created (2003).



### 3. Performance of the Chilean economy

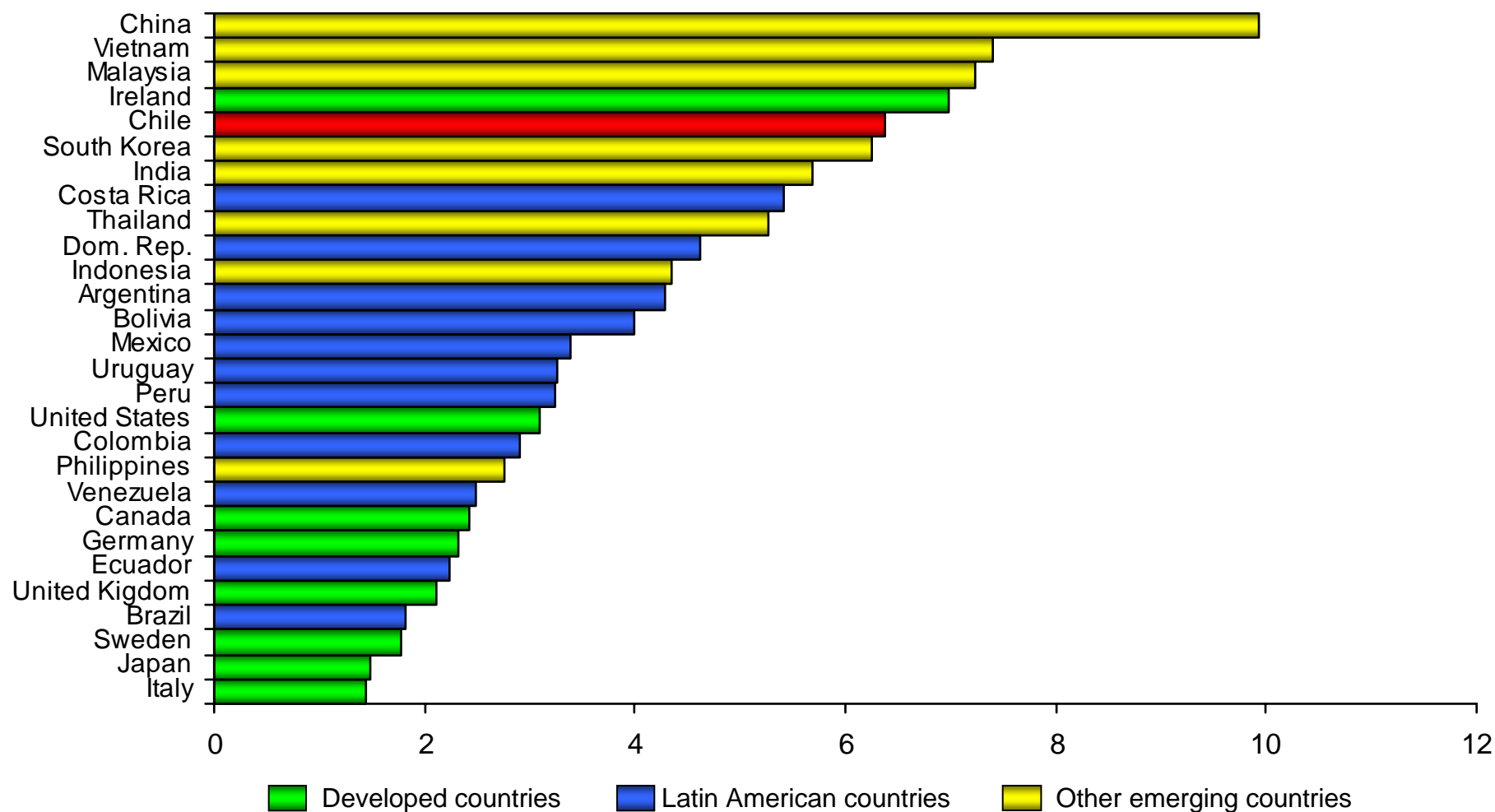


# Economic performance

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



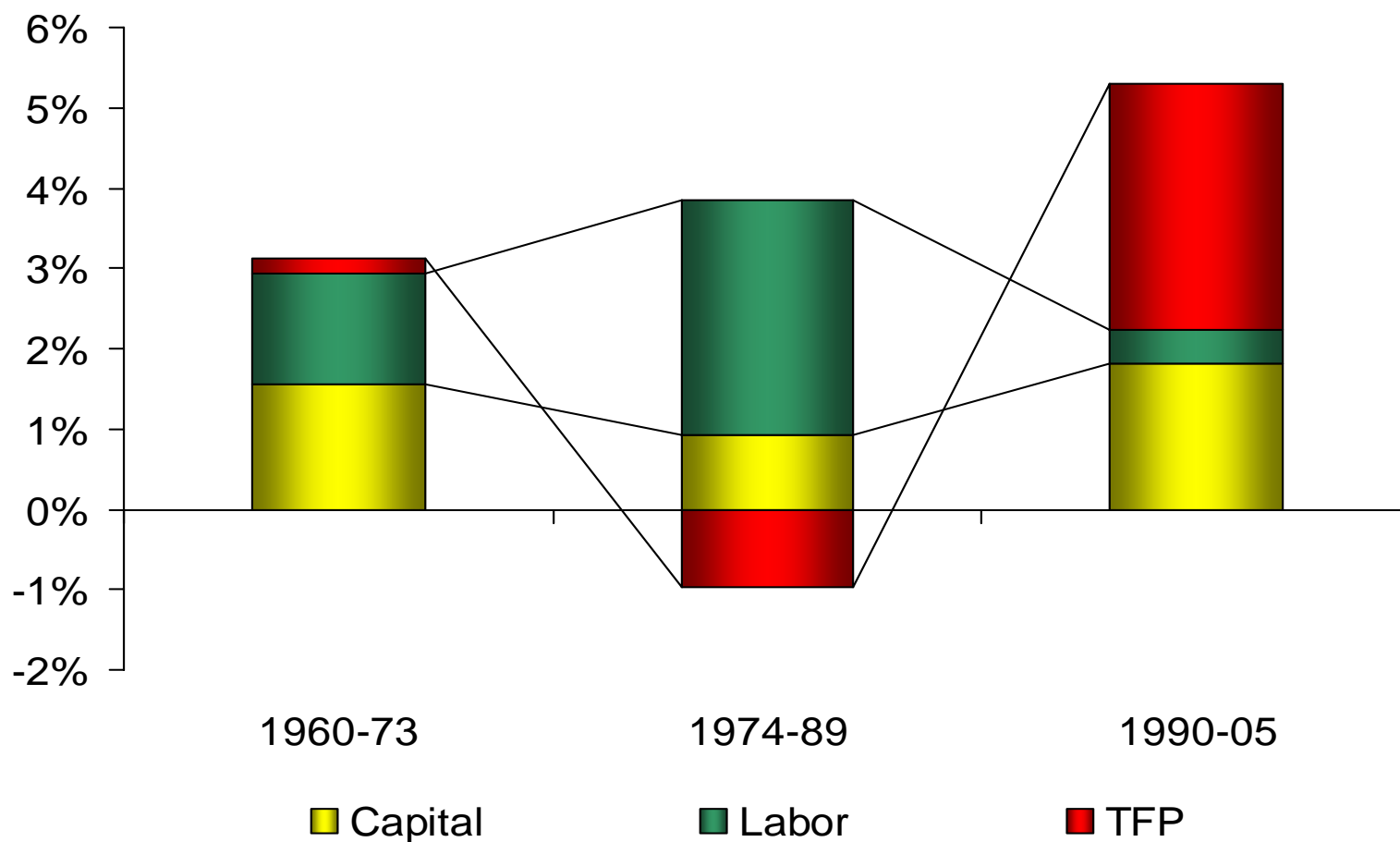
# Economic growth during the nineties (% per year)



Source: IMF.



# Solow's decomposition of economic growth: Chile



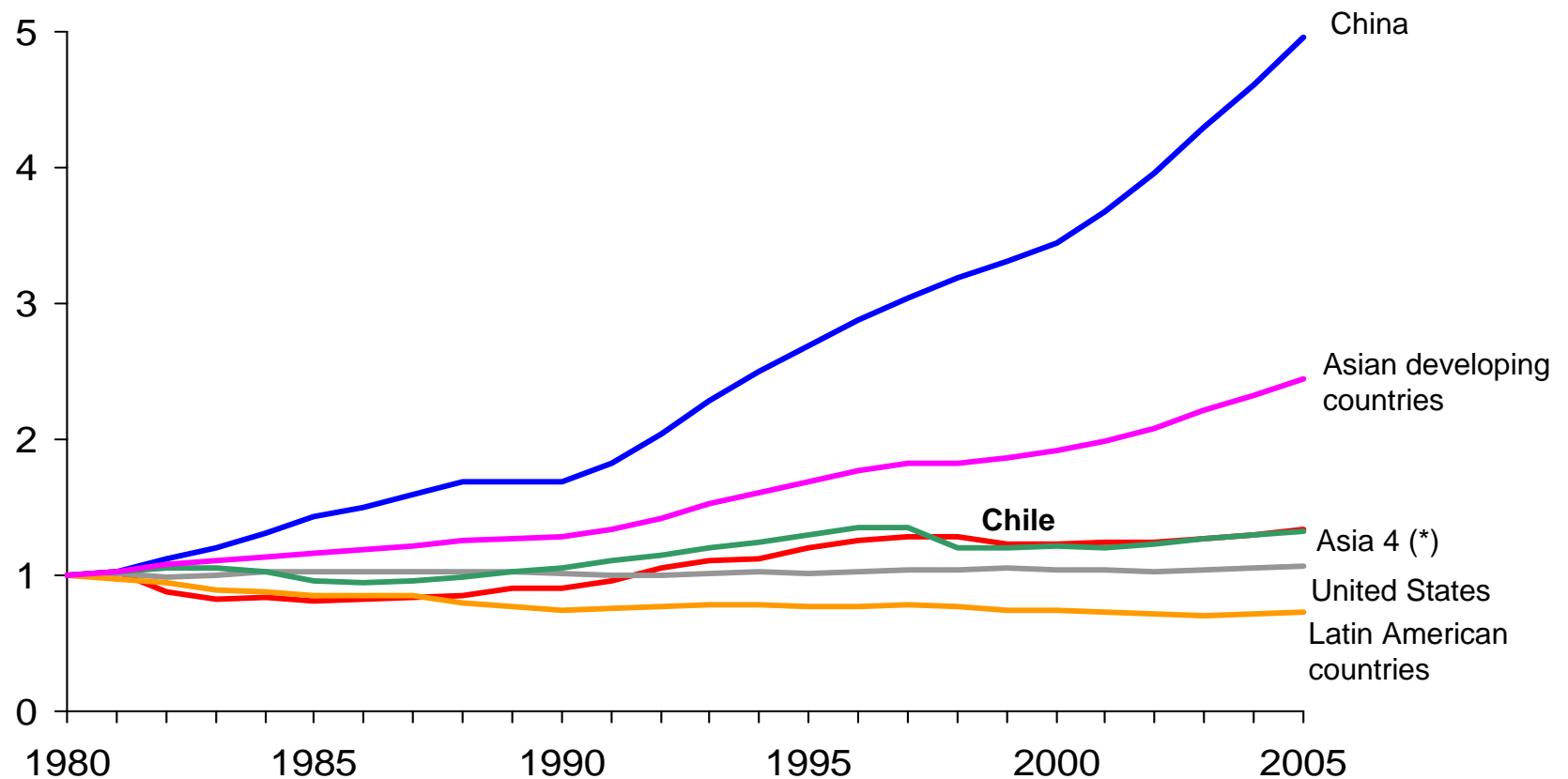
Source: Fuentes, Larraín and Schmidt Hebbel (2004).





# Relative per capita output

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

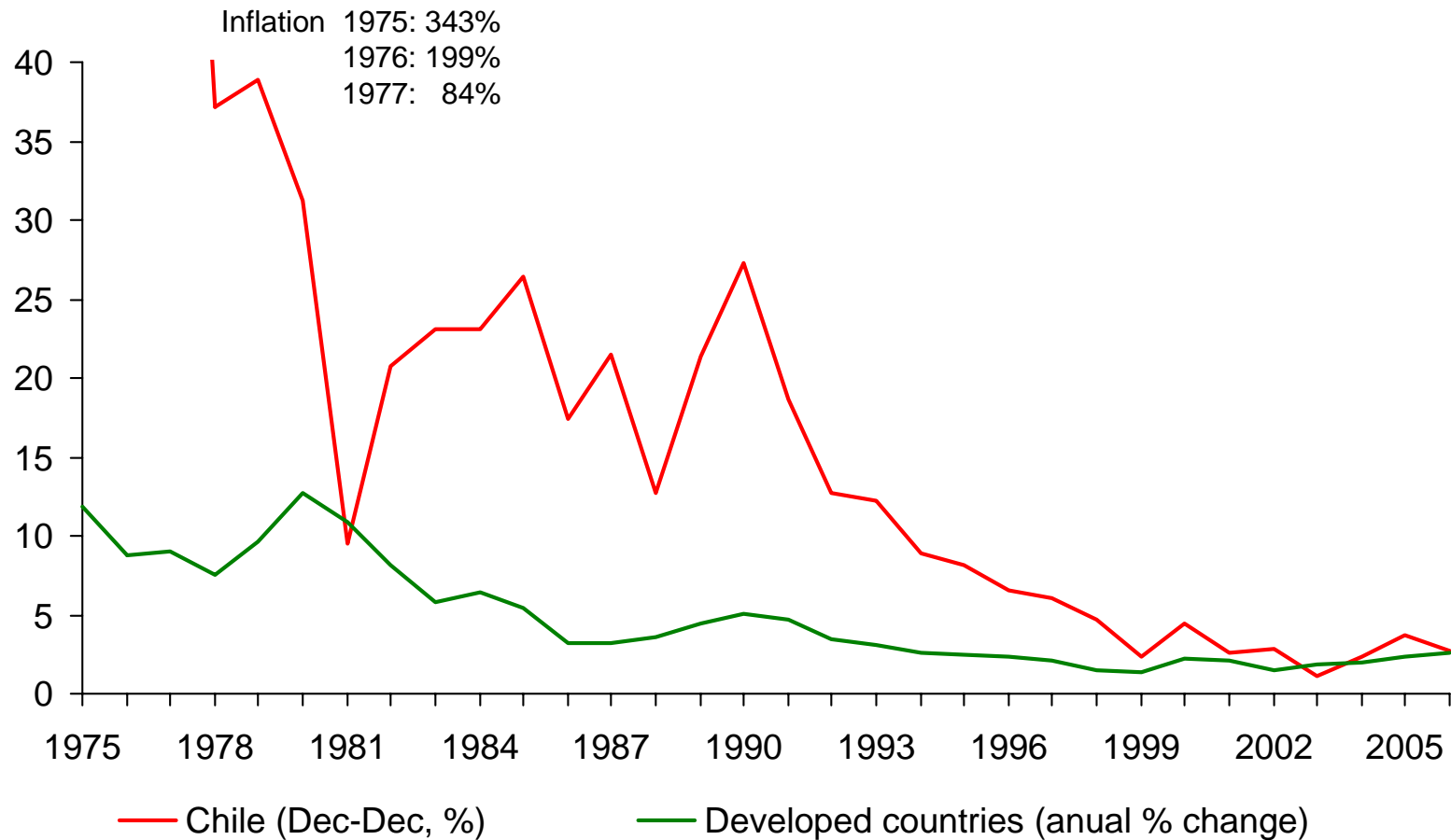


(\*) Asian 4: Malaysia, Indonesia, Thailand and Philippines.

Source: Own calculations.



# Inflation rate (1975-2006)



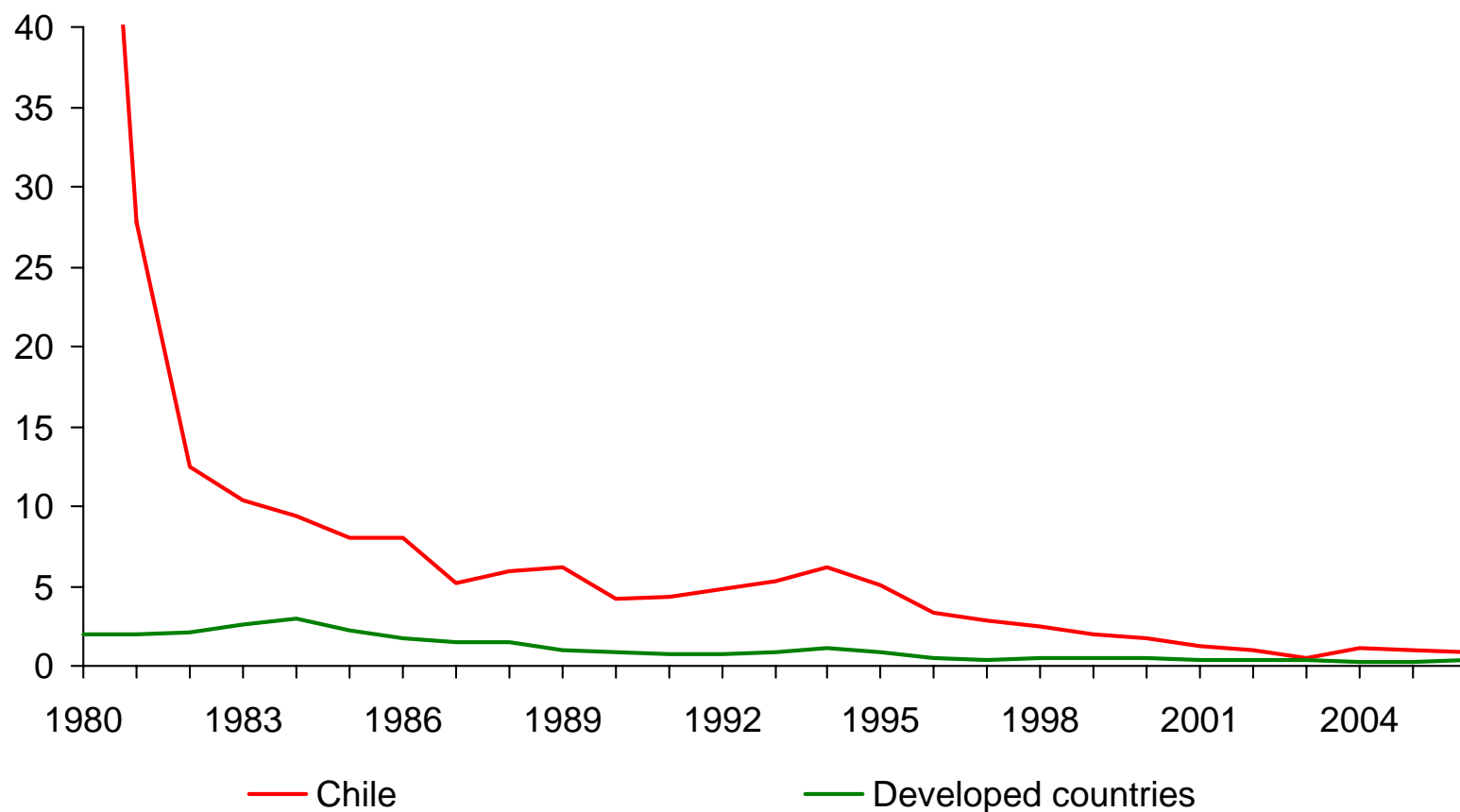
Note: For developed countries, data 2006 based on forecast *World Economic Outlook* (September 2006).

Sources: Central Bank of Chile and IMF.



# Inflation volatility

(standard deviation of rolling five-year window)



Sources: Central Bank of Chile and *IMF*.



# Successful monetary policy

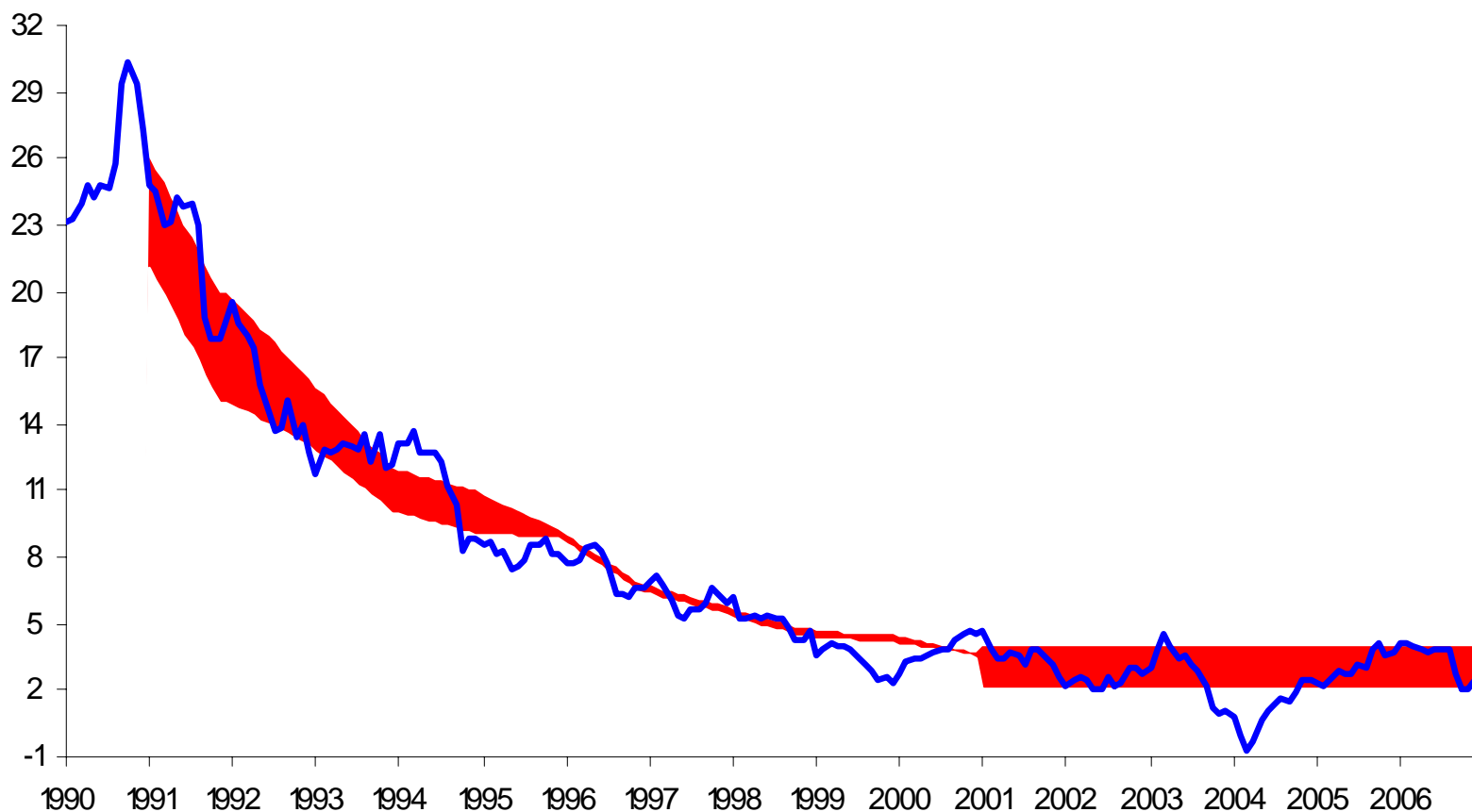
- The inflation target, maintaining inflation most of the time around 3% with a tolerance range of +/- 1 percentage point, has been reached successfully:
  - From Jan 2000-Dec 2006: Inflation averaged 2.9%;
  - As a percentage of time (months), annual inflation has fallen:

below 2%	between 2% and 4%	over 4%
15.5%	73.8%	10.7%

- Among 19 inflation-targeting countries, Chile ranks first in terms of smaller deviation from target and first in global inflation-targeting success (magnitude, persistence and frequency of deviation episodes).



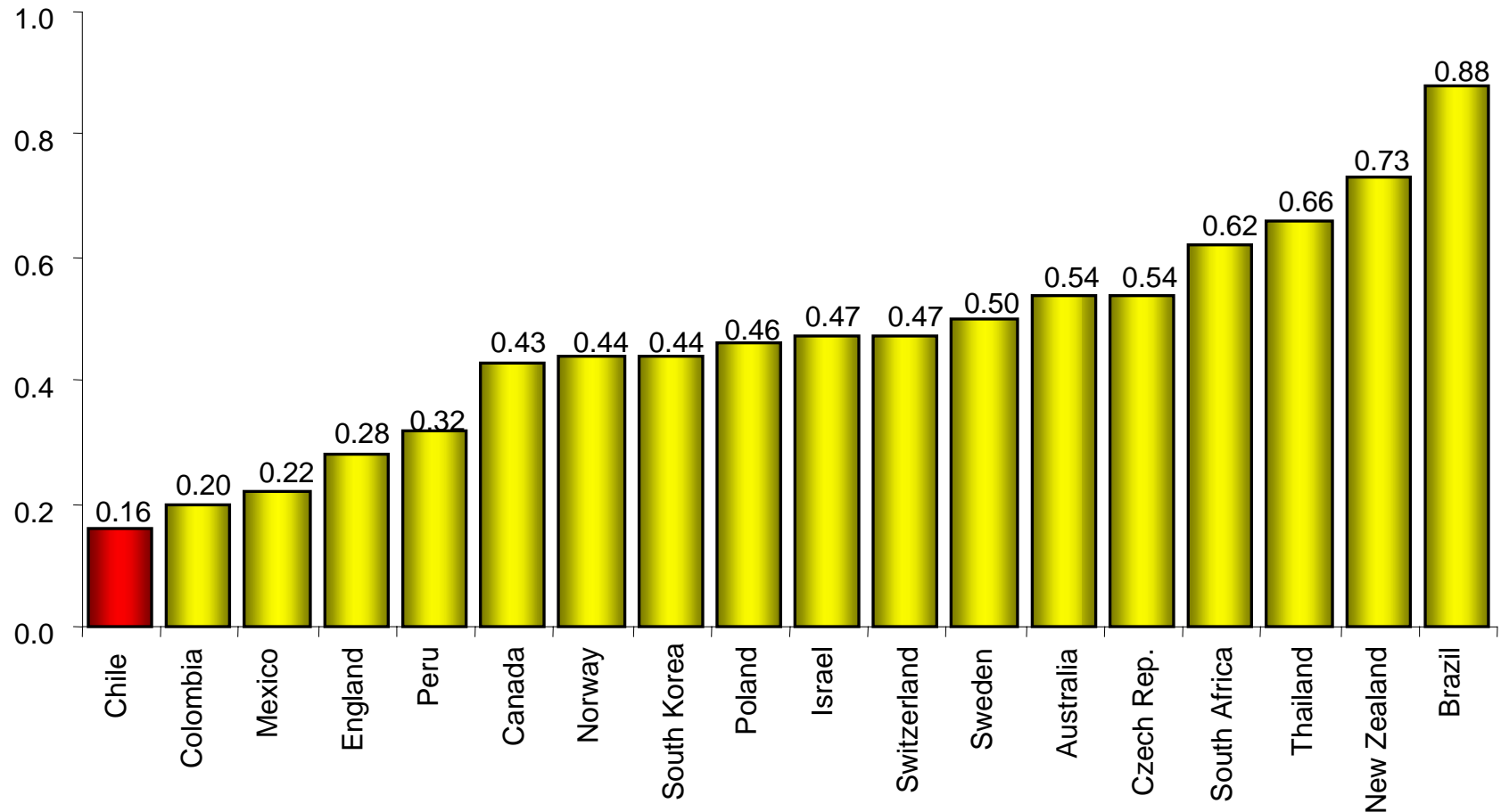
# Inflation target and inflation rate (monthly average, annual percent change)



Source: Central Bank of Chile.



# Relative deviations to the year 2004 (%)



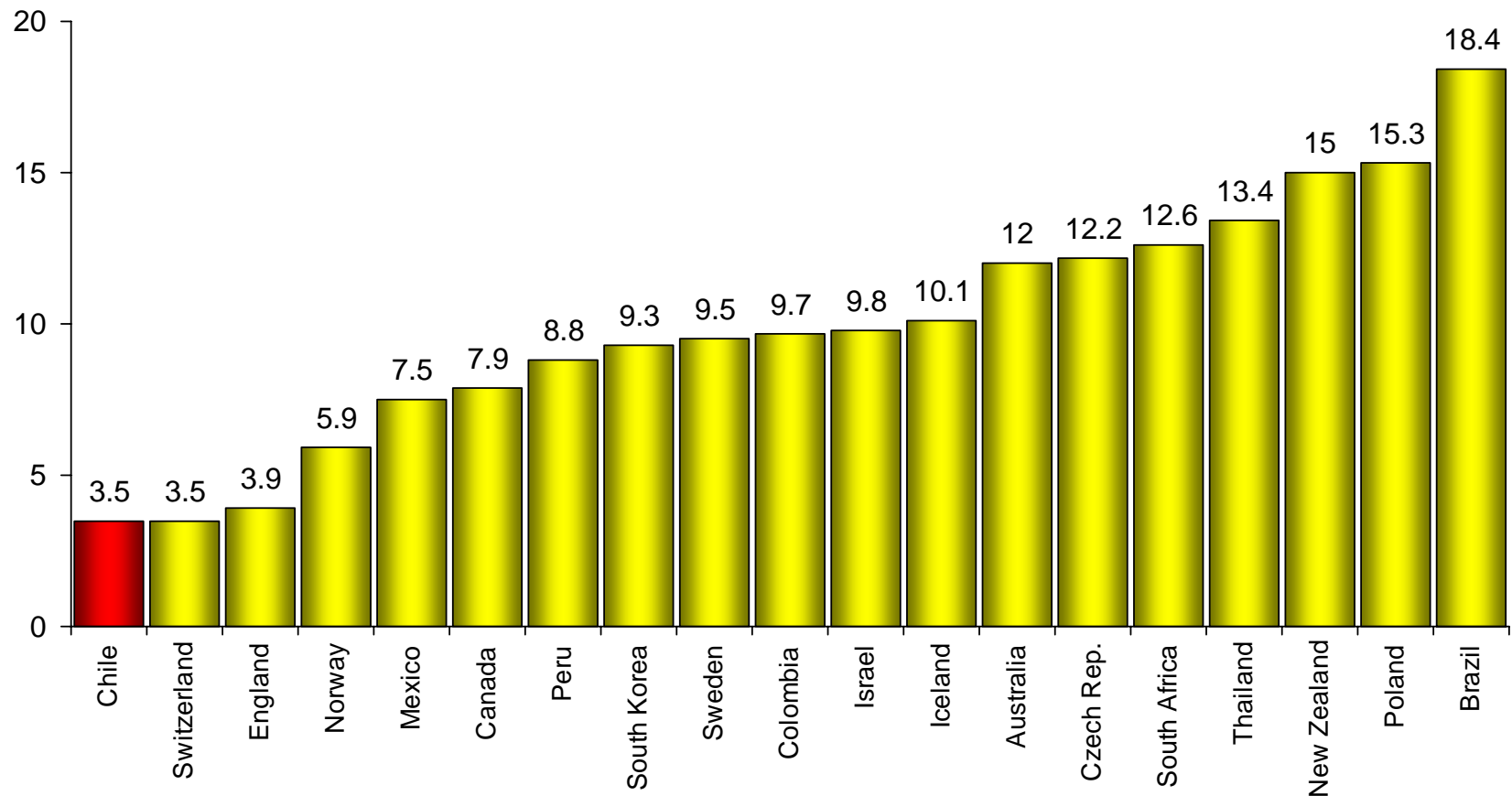
Note: Considers the starting period of an inflation-targeting scheme to the year 2004.

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

Source: Albagli and Schmidt-Hebbel (2005).



# Aggregate performance index



Note: The index considers inflation rate deviation with respect to the target in countries with inflation-targeting schemes, since the start of inflation targeting through December 2004.

Source: Albagli and Schmidt-Hebbel (2005).



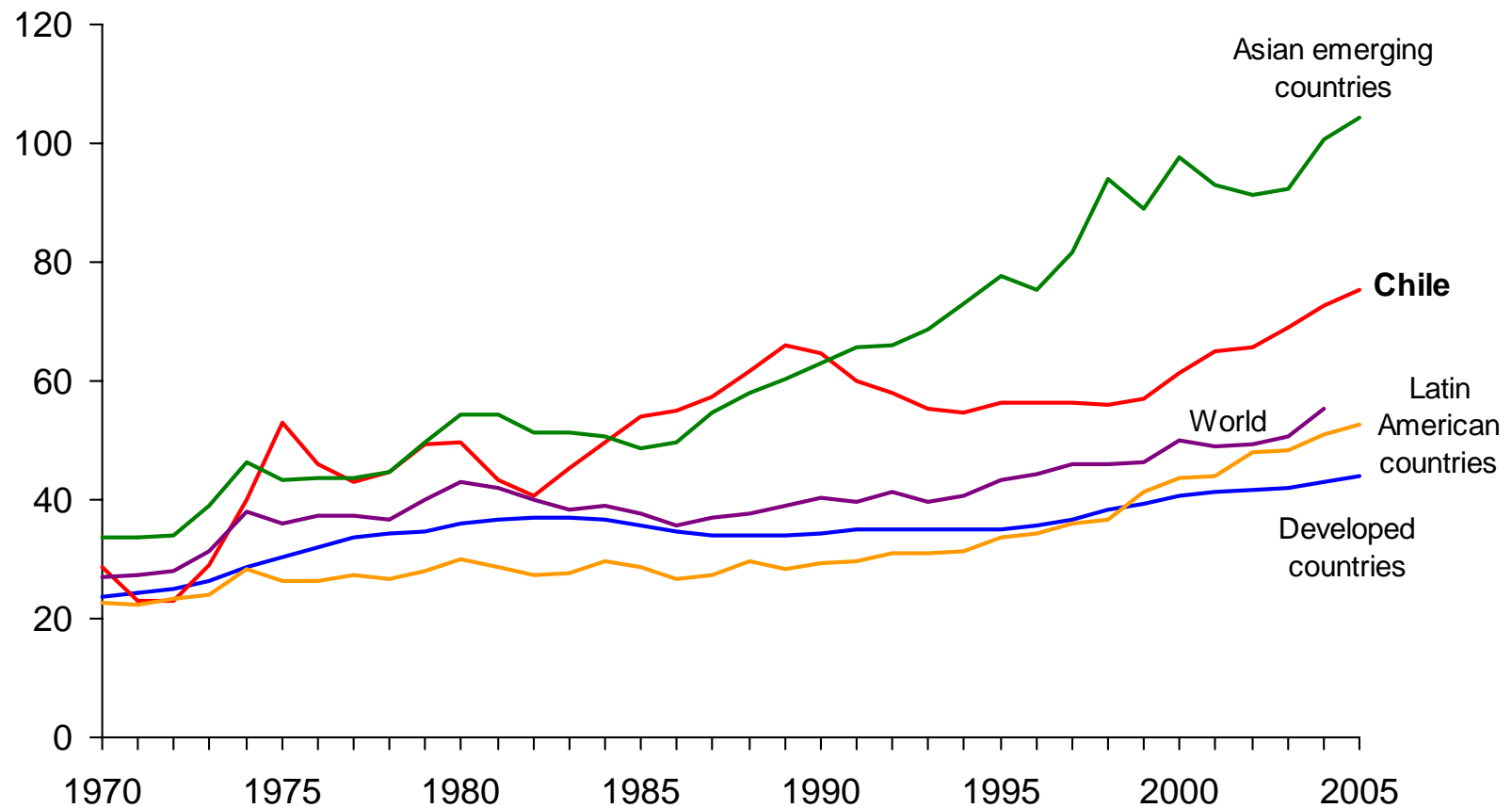
# Commercial and financial integration

- Due to the continuing process of commercial integration, Chile experienced a notably trade performance. Trade openness is higher compared to other Latin American countries and to world average.
- Chile's financial integration has increased remarkably since the 1990s. Financial openness is considerably higher than in other emerging countries, achieving developed-market levels.





# Trade openness (% GDP, 1970-2005)

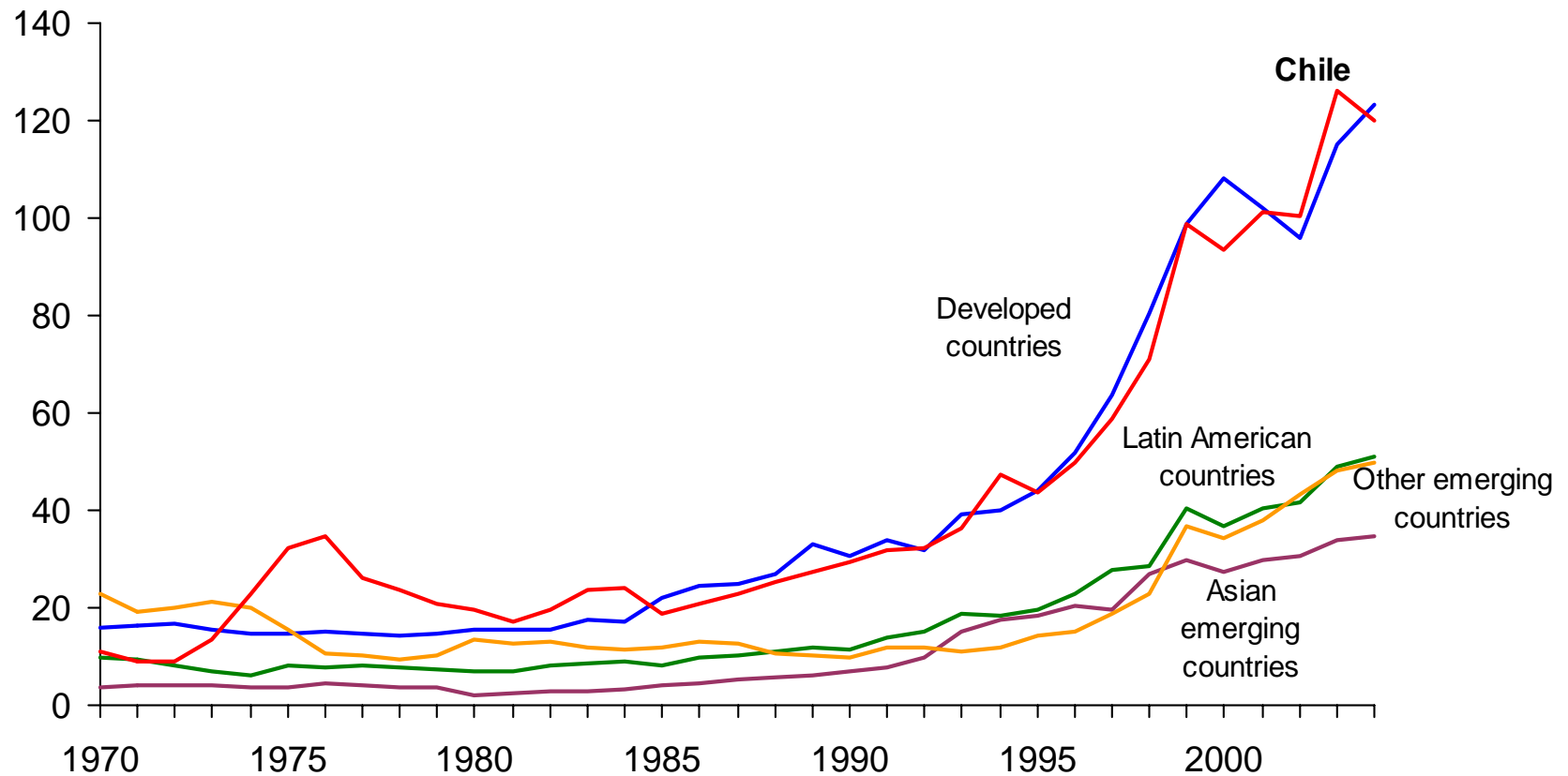


Note: Measured as the sum of exports and imports in percent of GDP.

Sources: *World Bank* and *IMF*.



# Financial openness (% GDP, 1970-2004)



Note: Measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment in percent of GDP.

Sources: Lane, Philip and Gian Maria Milesi-Ferretti (2006) and IMF.



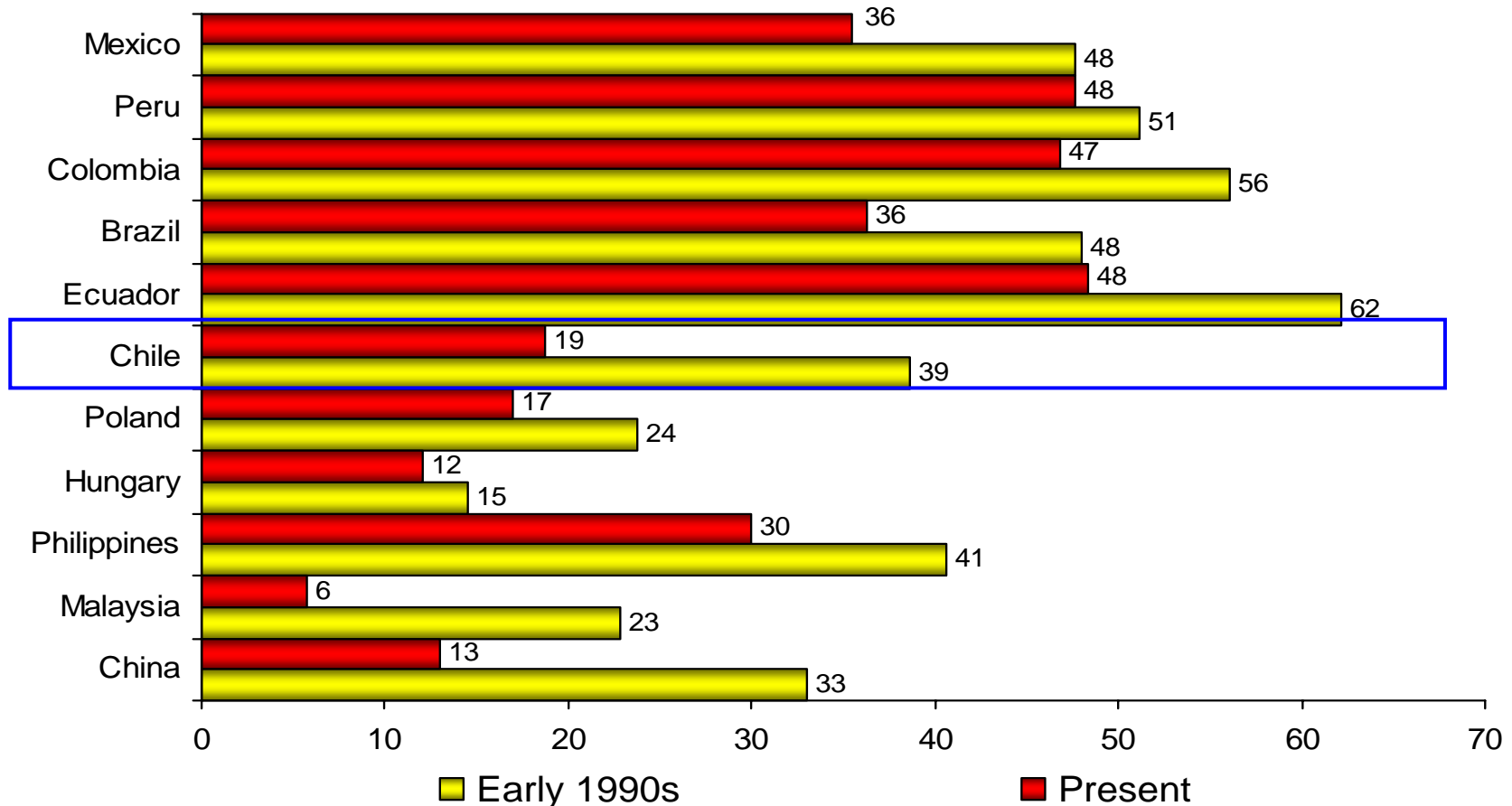
# Social indicators

- 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.



# Poverty rate

(%, population below poverty line)

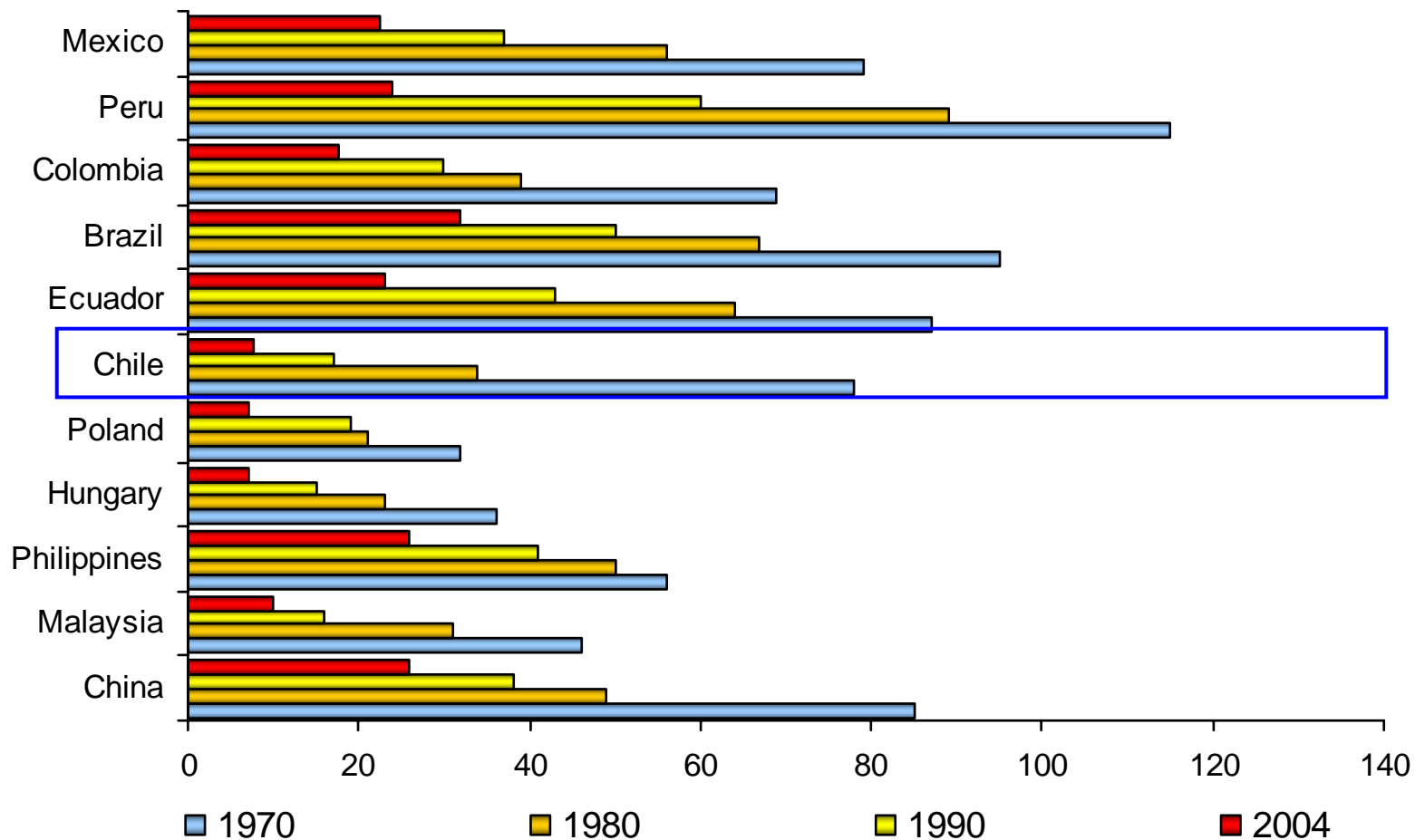


Note: Present stands for 2005 in Mexico, Colombia, Brazil and Ecuador; for 2004 in Malaysia and Peru; for 2003 in Chile, Poland, Hungary, China and Philippines.

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



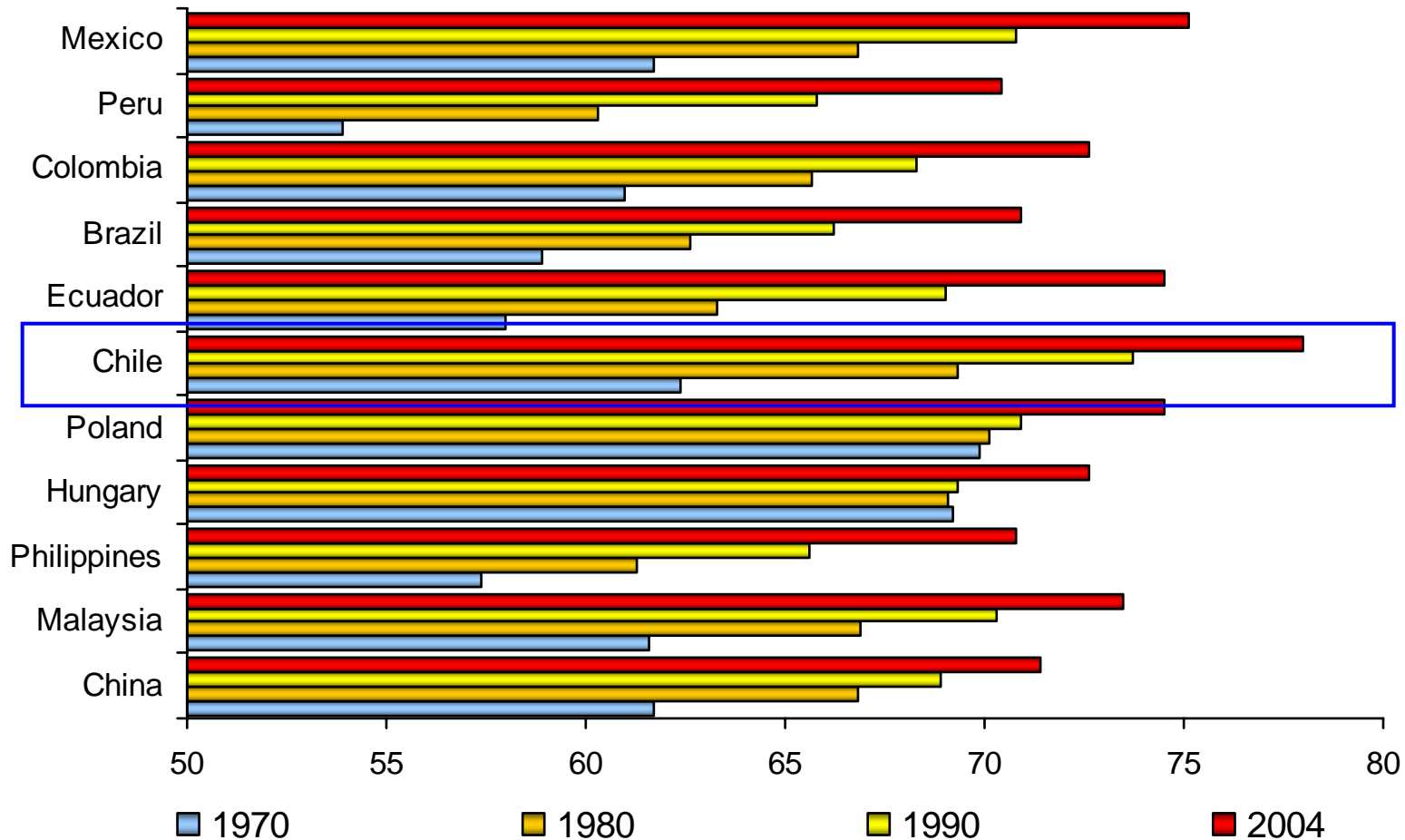
# Infant mortality (per 1000 live births)



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



# Life expectancy at birth (total years)



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

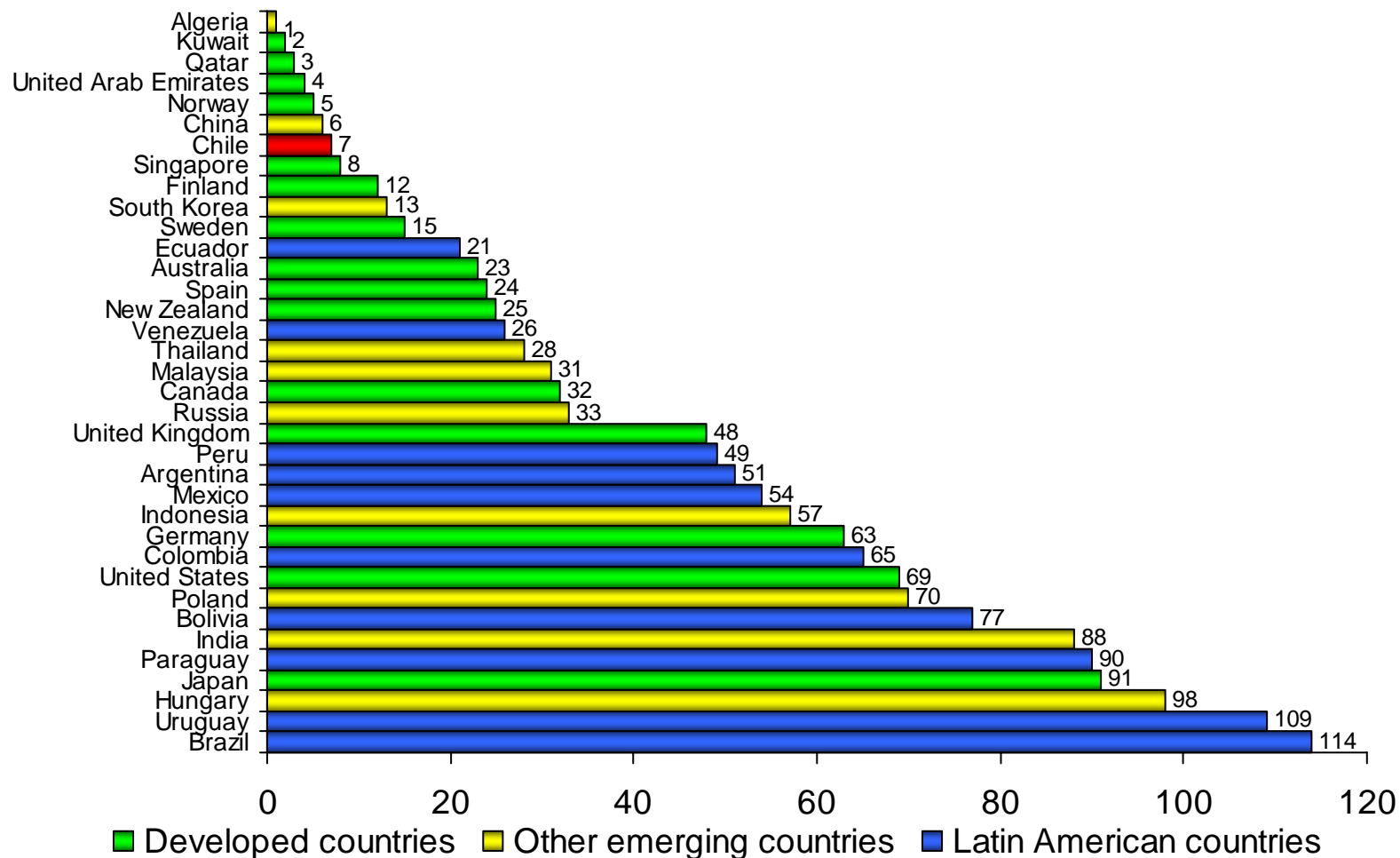


# Main strengths

- As a result of all of 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:
  - A proved 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)



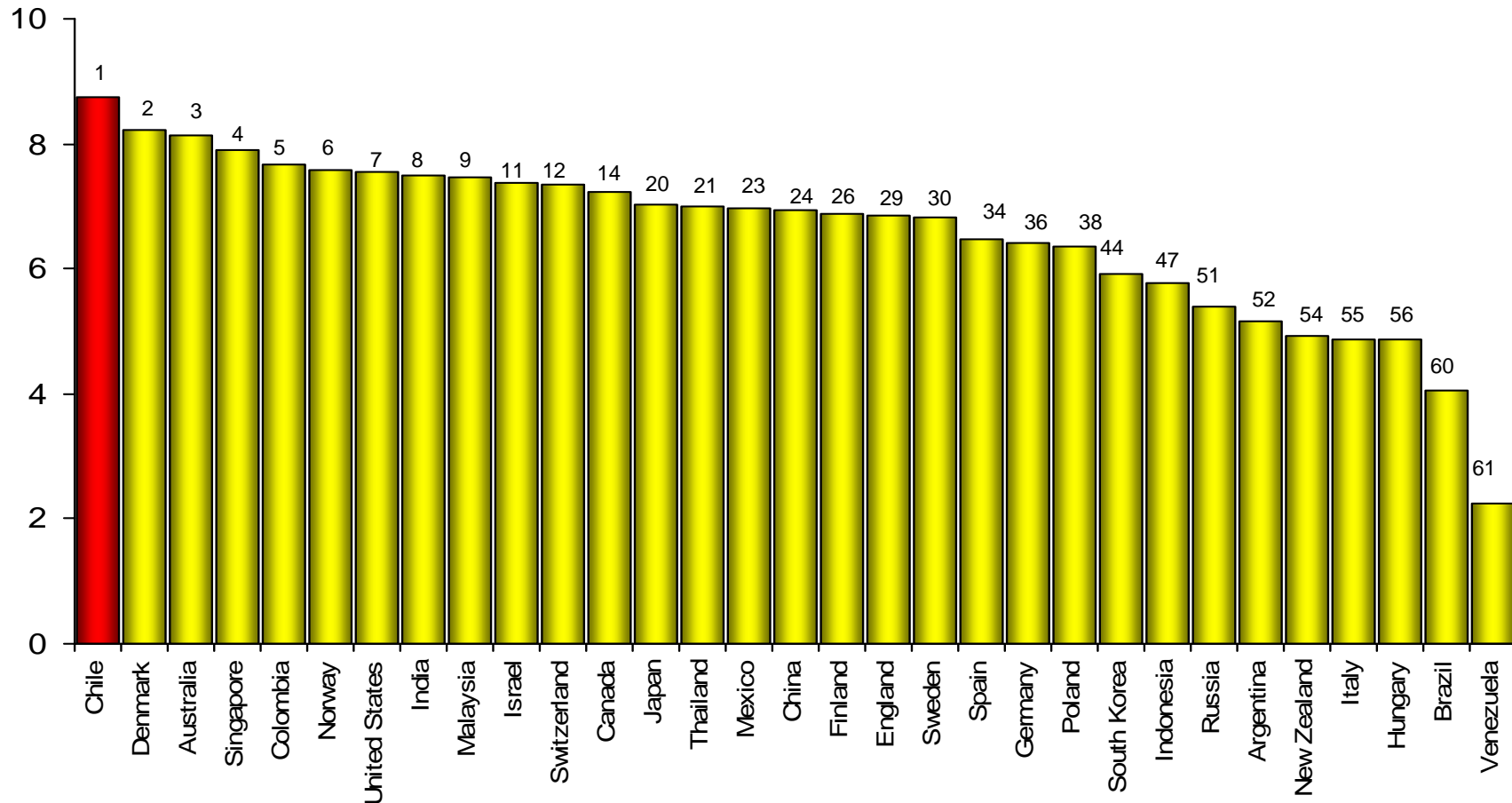
Note: The number beside each bar represents the place in the ranking.

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





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



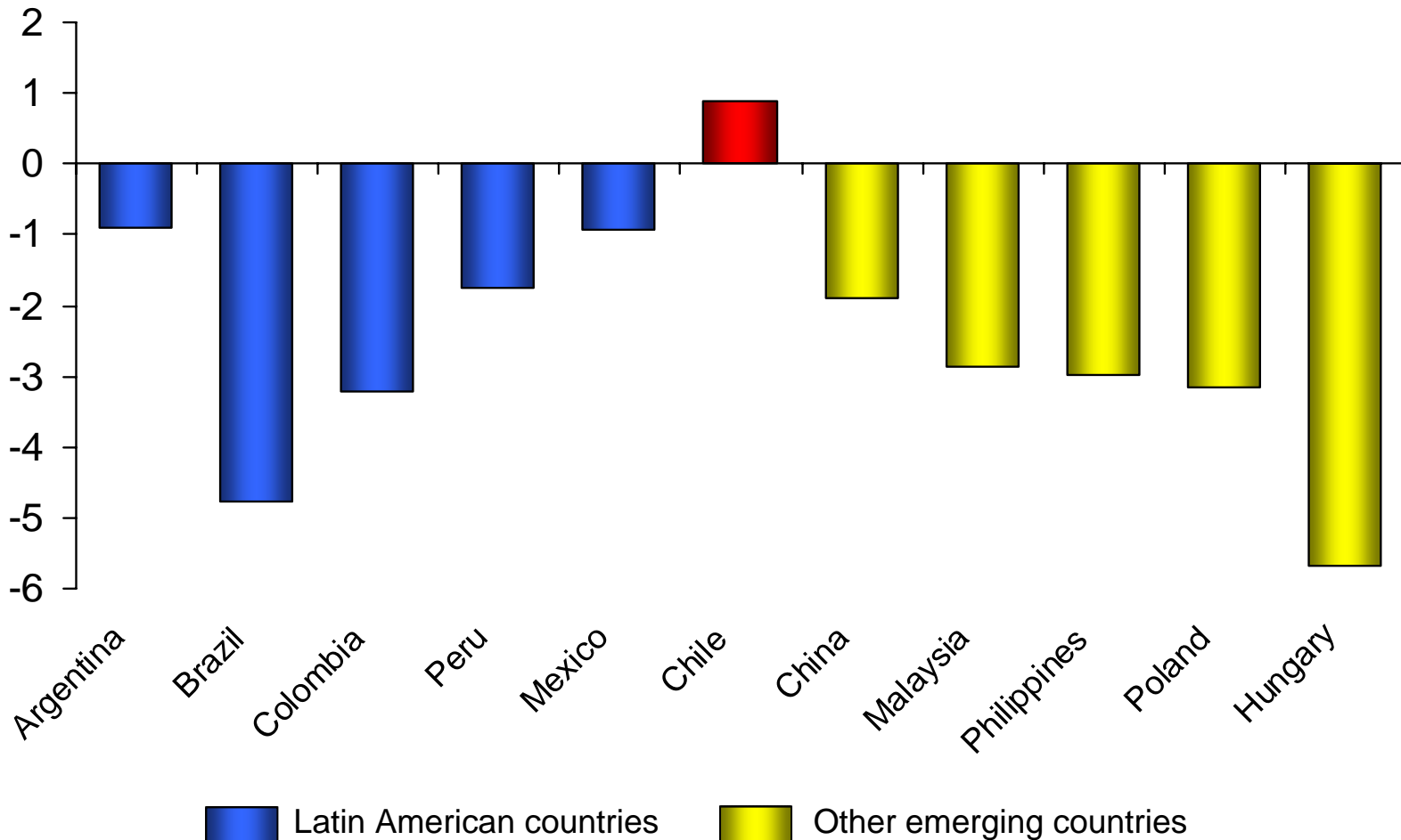
Note: It is quantified in a scale from 1 to 9. The number over each bar represents the place in the ranking.

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



# Fiscal balance

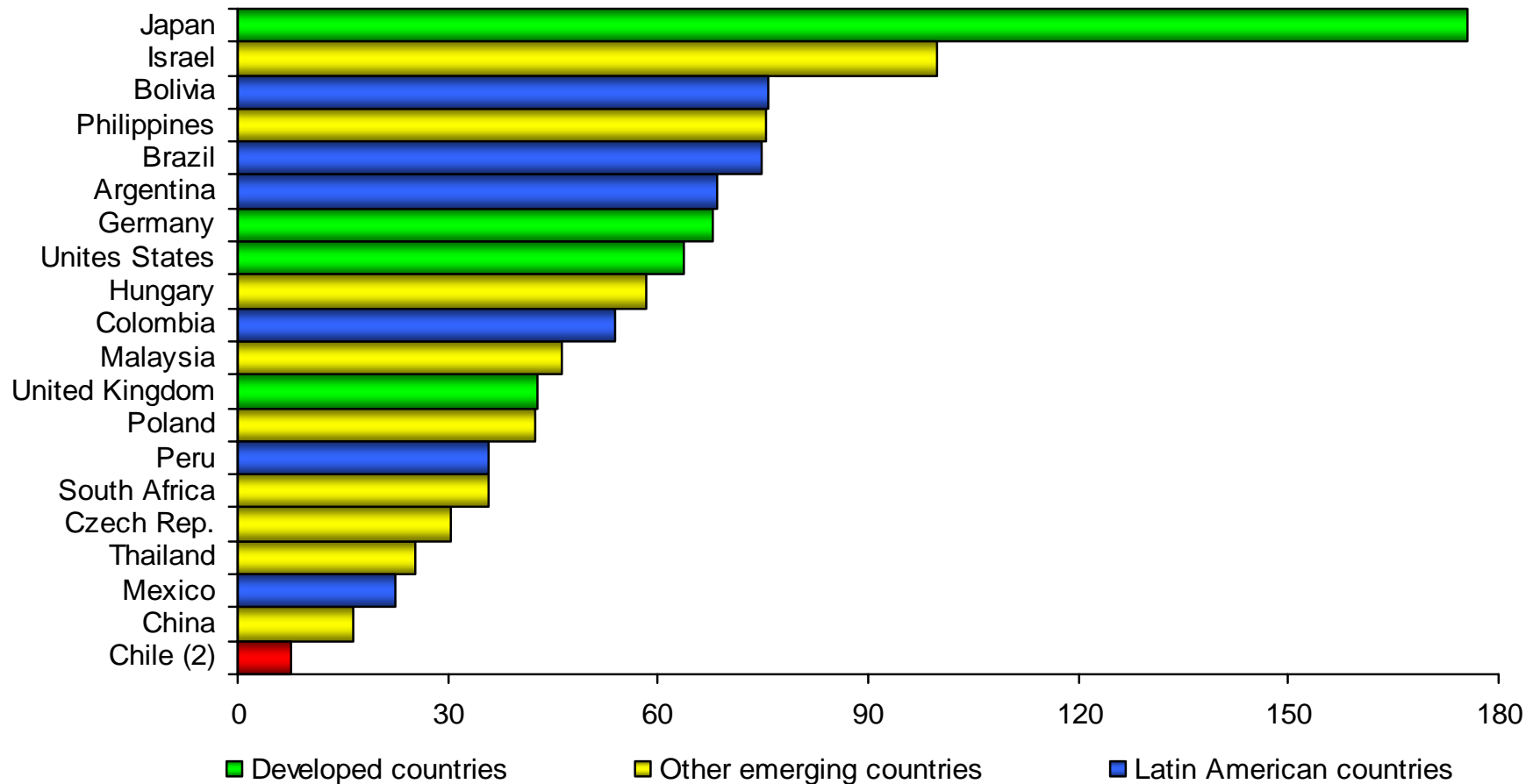
(% GDP, average 1995-2005)



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



# Public debt (1) (% GDP, 2005)

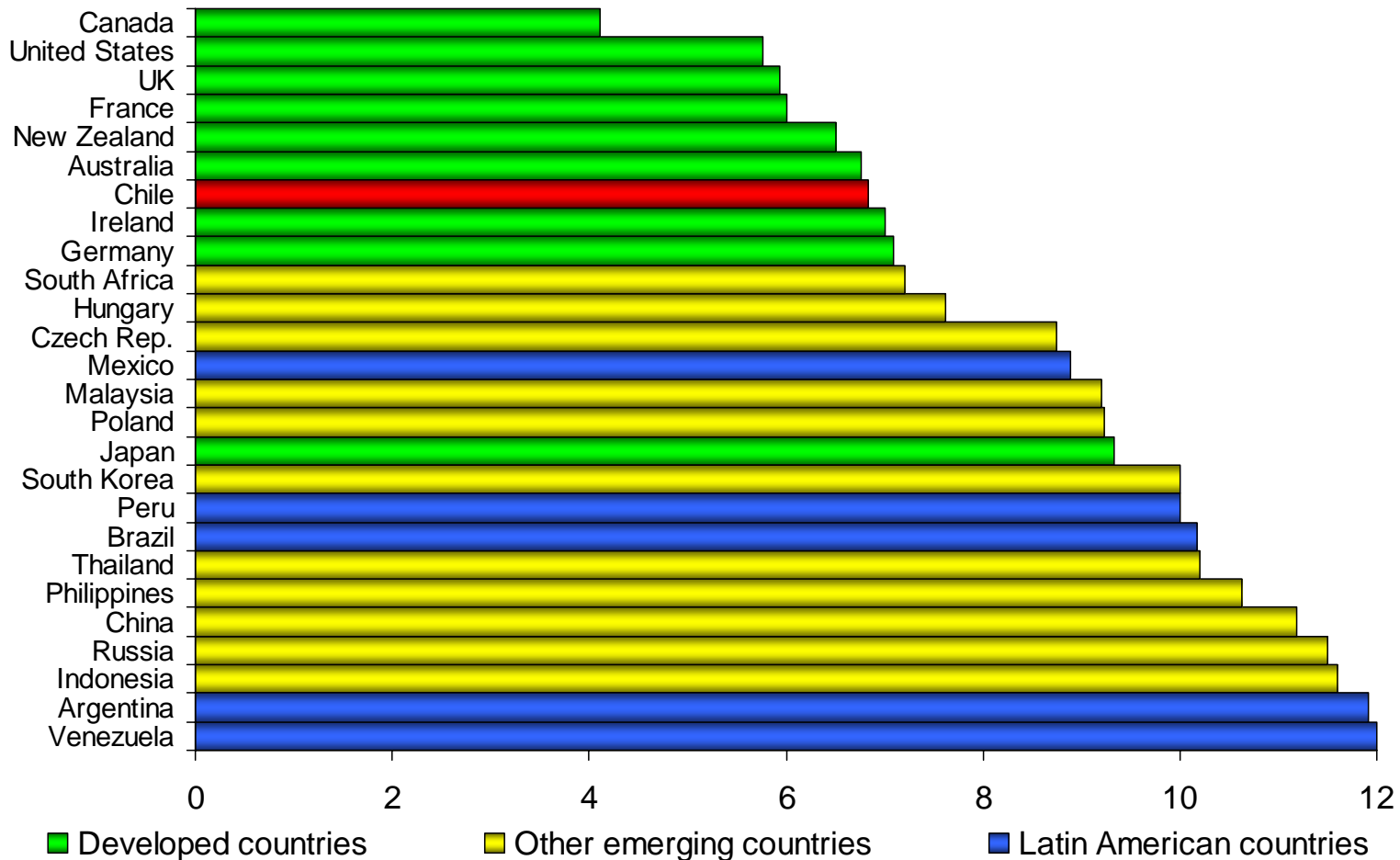


(1) General government debt. (2) As of September 2006.

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



# Banking system strength (index, 2006)

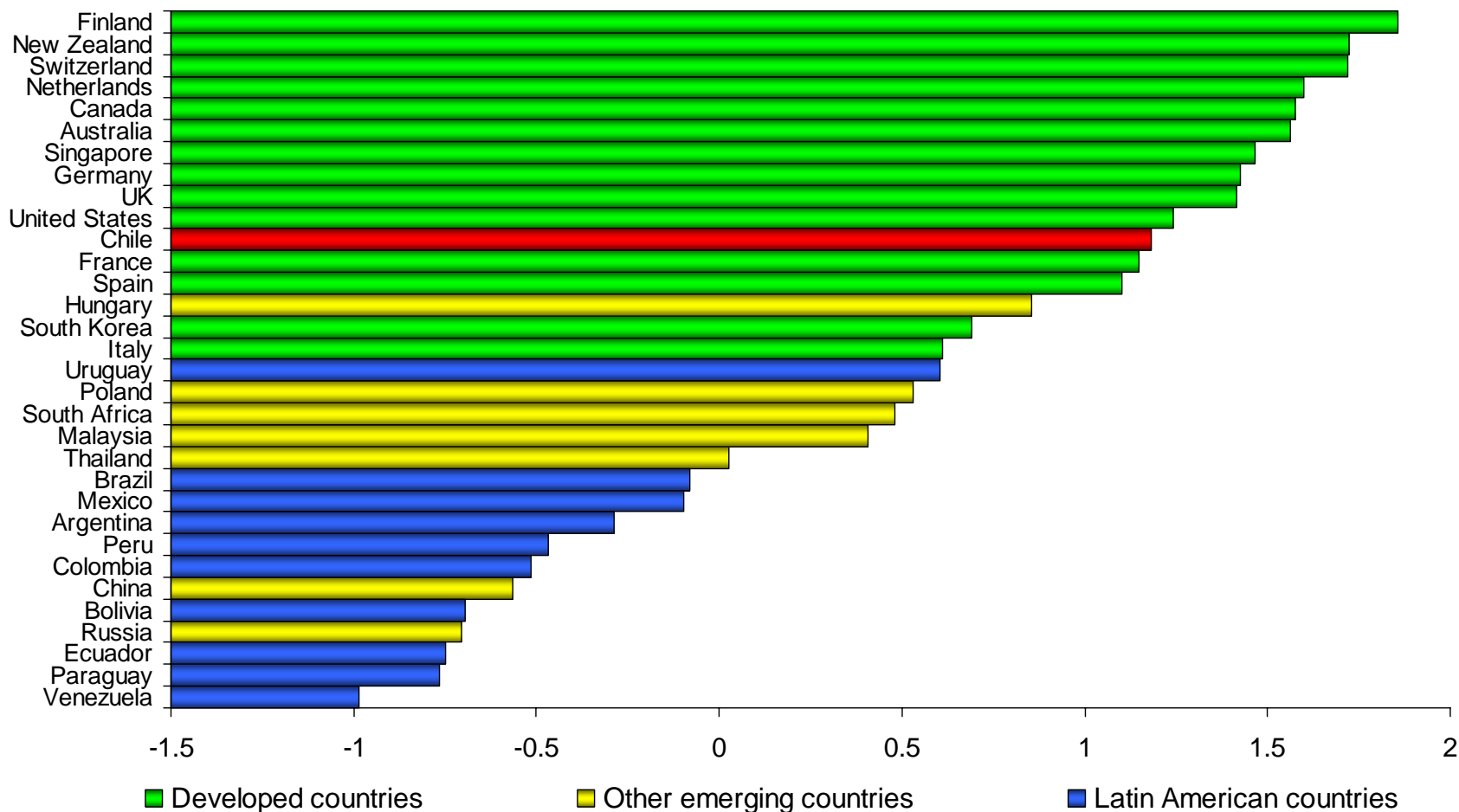


Note: It is quantified in a scale from 1 to 13.

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



# Quality of institutions (index, 2005)

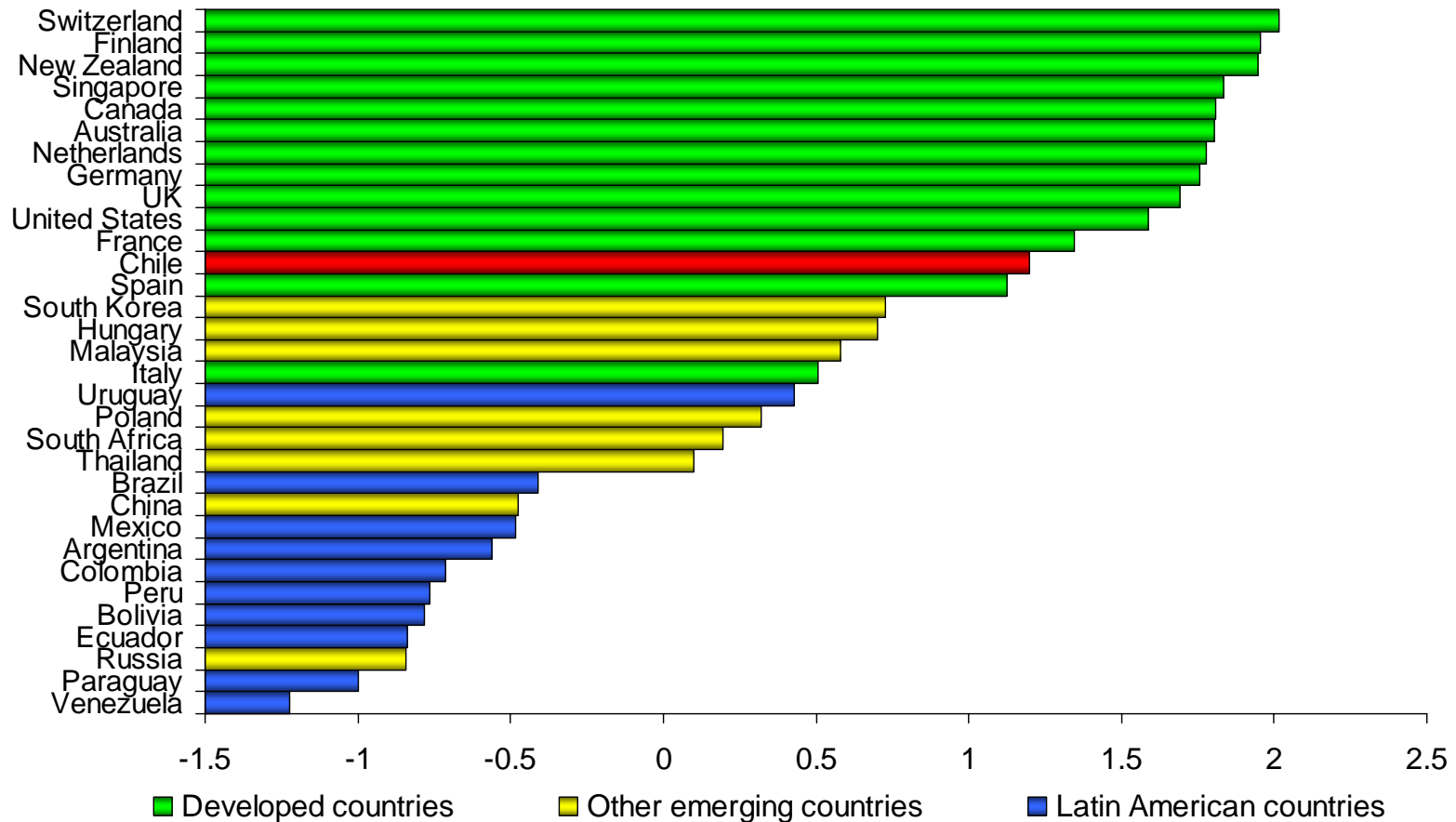


Note: Average of six indexes: rule of law, corruption control, political stability, quality of regulations, government effectiveness, and accountability.

Source: *World Bank* (September 2006).



# Rule of law (index, 2005)



Note: Index measures protection of individuals and property against violence or theft, independent and effective judges, and contract enforcement.

Source: *World Bank* (September 2006).

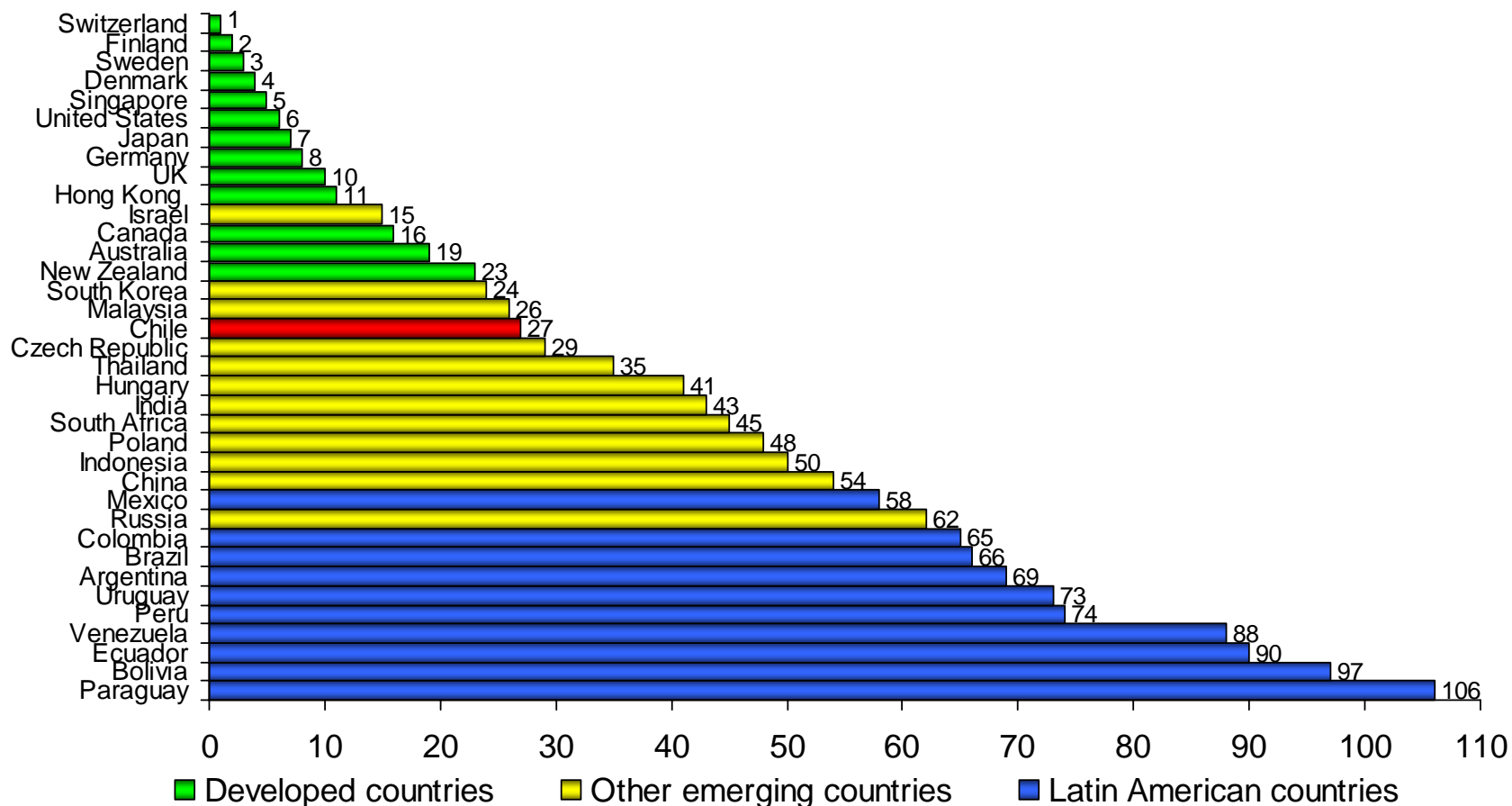


# Good international evaluation

- Chile is today one of the most competitive emerging market economies;
- Country risk is among the lowest;
- Moreover, the *World Bank* report on the ease of doing business ranks Chile 28<sup>th</sup> among 175 countries in 2006. Chile is top of the list in the region.



# Competitiveness (ranking, 2006)



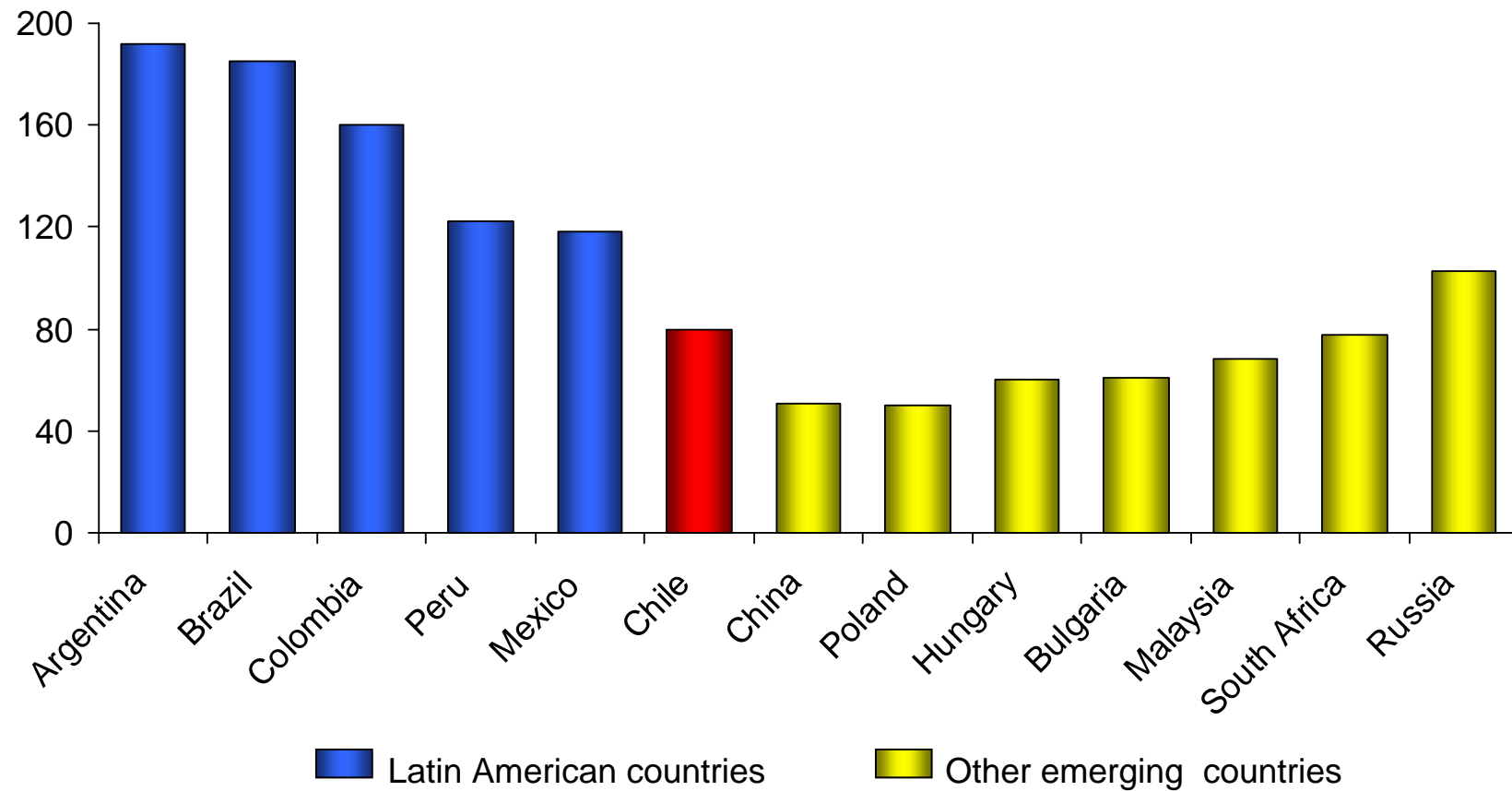
Note: The competitiveness index measures country's ability to achieve high and sustainable per capita GDP growth. The number beside each bar represents the place in the ranking.

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





# Country risk (basis points)

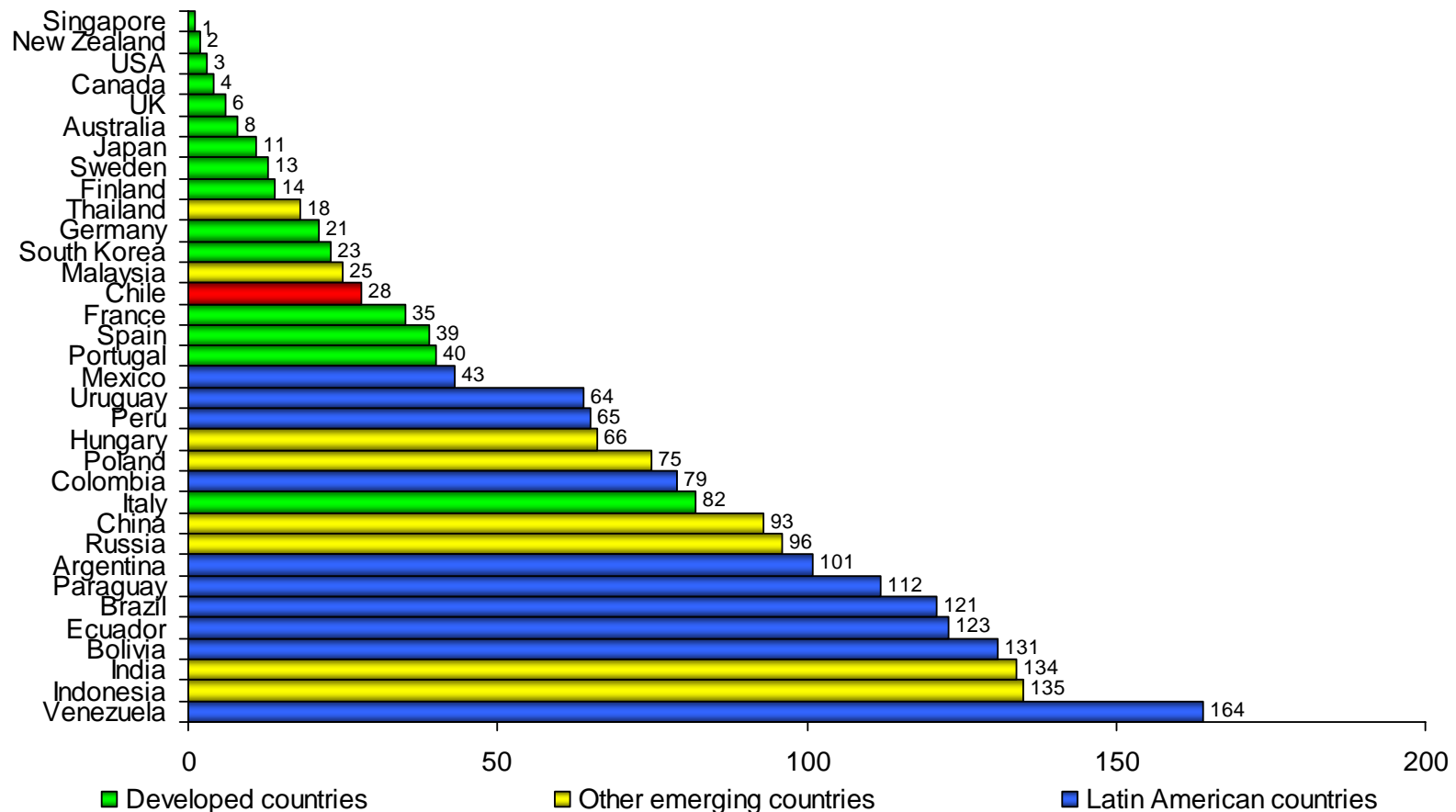


Note: As of January 19, 2007.

Source: JP Morgan Chase.



# Ease of doing business (ranking, 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. The number beside each bar represents the place in the ranking. Source: *World Bank* (2006).

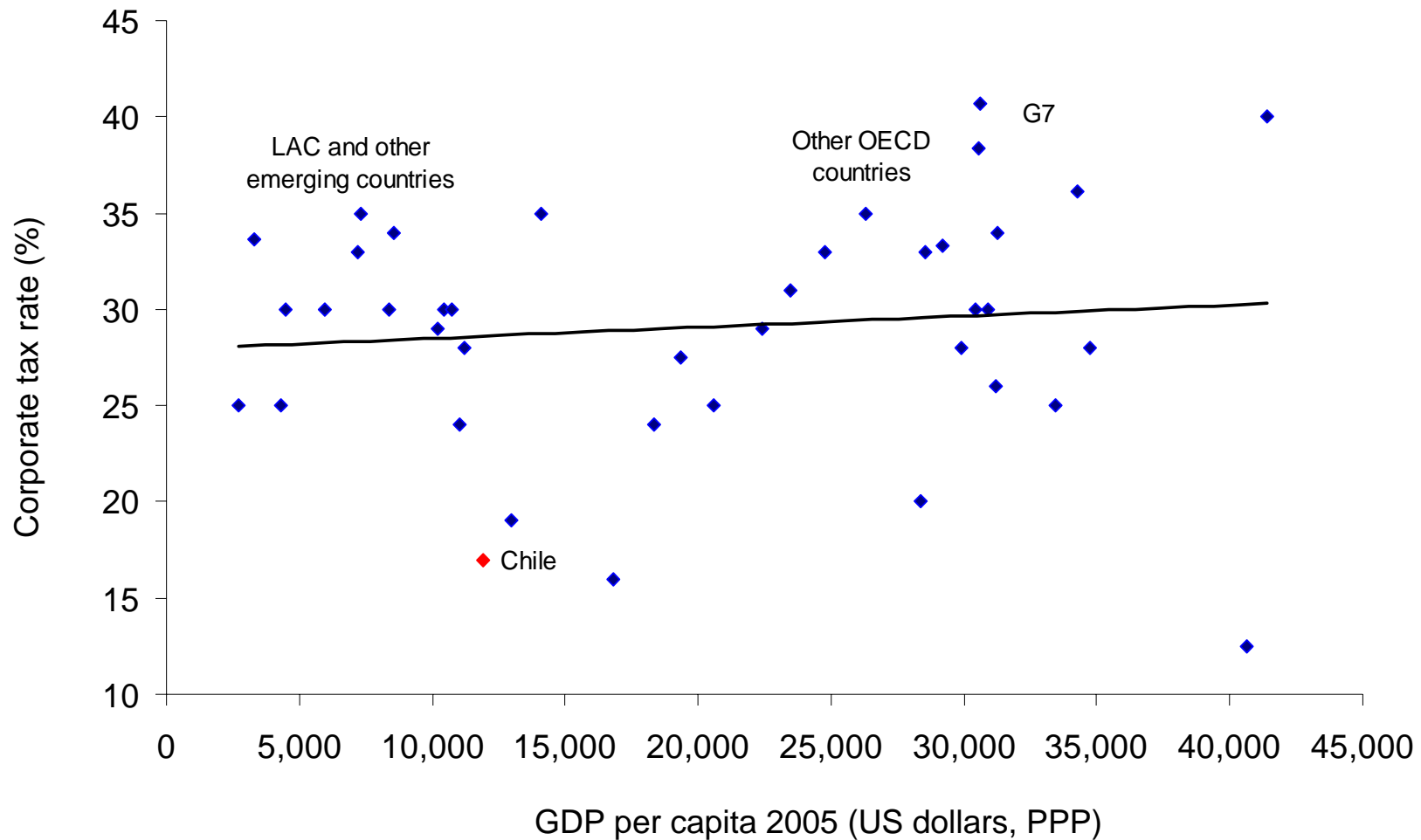


# Attractive tax system

- Chile's tax system is attractive to investors:
  - Tax burden is low according to per capita income;
  - Corporate tax is among the lowest (17%);
  - Tax system is efficient:
    - Based on a VAT complementing the income tax that includes several exemptions to eliminate distortions to saving.
  - Integrated tax system: corporate tax is discounted from personal income taxes.



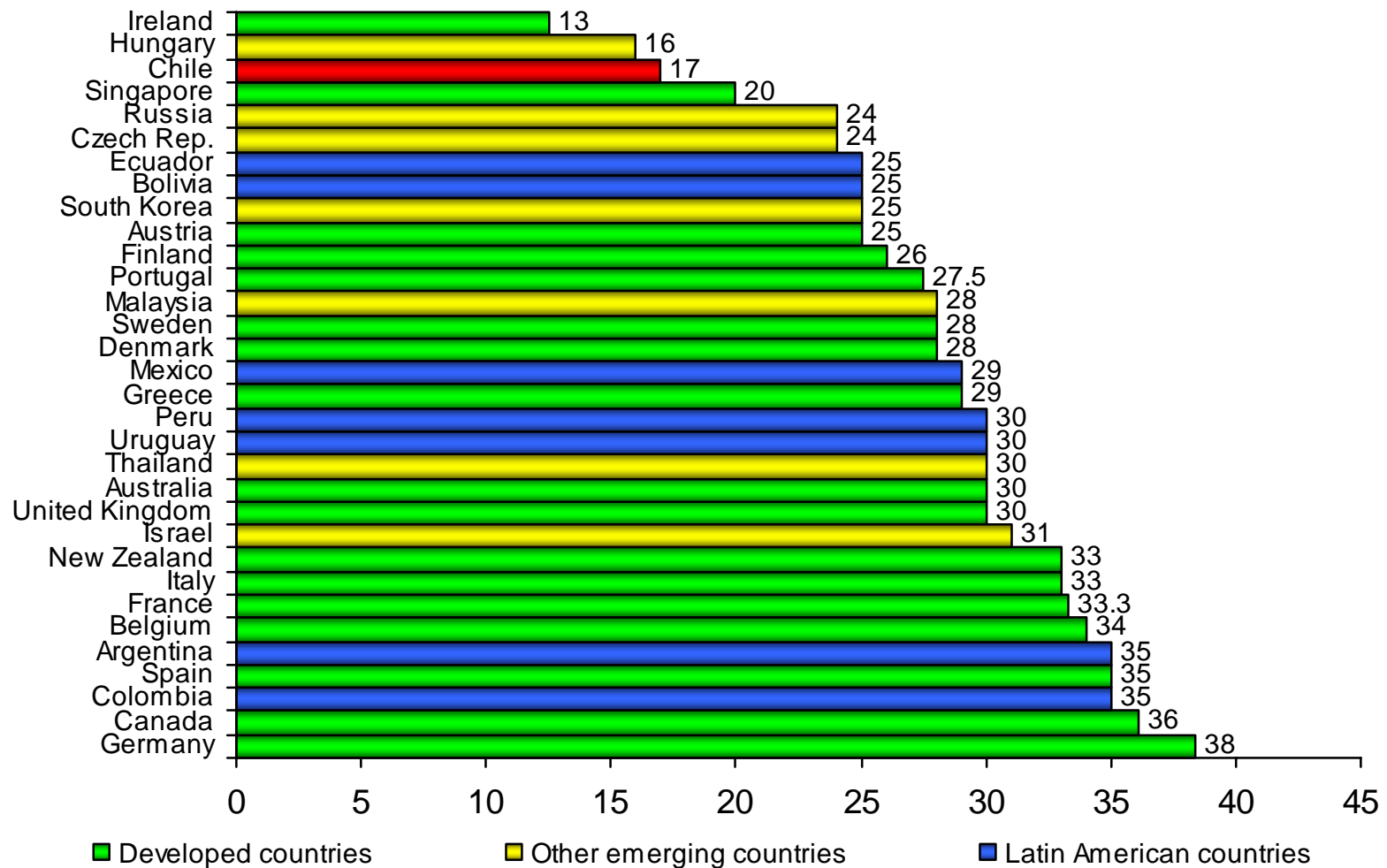
# Tax burden and per capita income (2006)



Sources: *PricewaterhouseCoopers* and *IMF*.



# Corporate tax rate (%, 2006)



Source: PricewaterhouseCoopers.



## 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;
  - Robust and sound financial sector;
  - Strong and stable institutional setting;
  - 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.
- GDP growth for 2007 is projected to be in the range of 5%-6%.
- But economic development is a continuous process, and Chile still faces important challenges:
  - Education, especially regarding quality;
  - Technological innovation.





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