The Chilean economy in a complex international scenario: present conditions and prospects

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I. Introduction

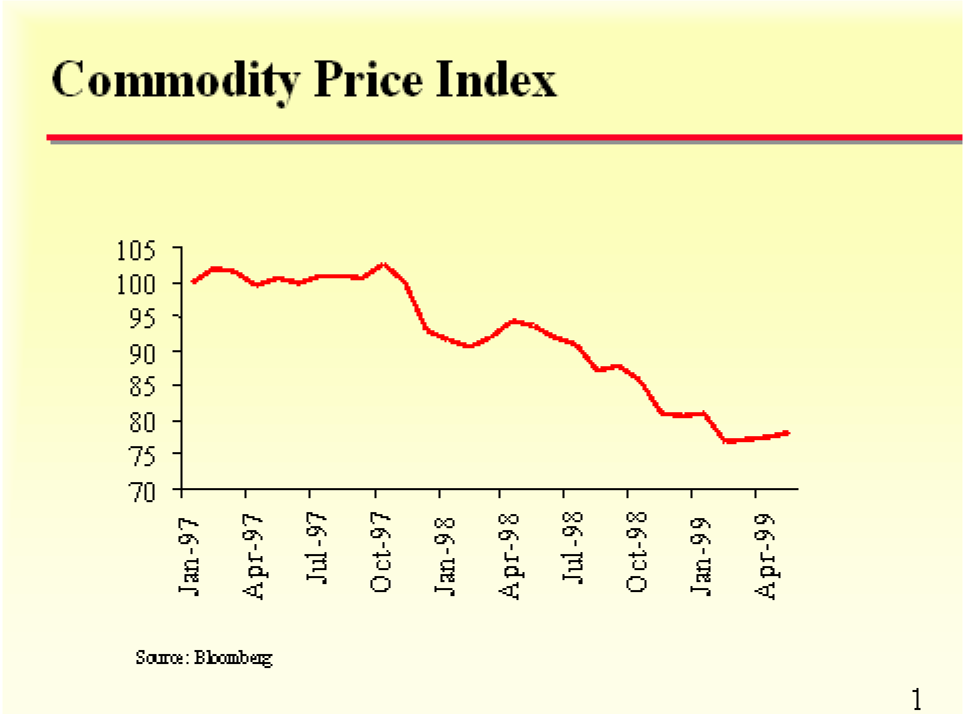
Like other emerging economies, Chile has been dealing with a complex international scenario over the last year and a half, which has involved a sharp cut back in external demand, a fall in the prices of our main export products, and a contraction in external financing. Although the shock was powerful, the Chilean economy has now seen off the main threats, having succeeded in implementing adjustment policies to correct excess spending. At the same time, the international economy is making a gradual recovery. A comparative analysis of country-risk indicators shows that the Chilean economy not only has fewer risk factors than the other emerging economies, but these have also come down since the beginning of the year.

The Chilean economy today is well placed to resume a sustained growth process. The current-account deficit has been reduced and is projected at prudent levels; inflation is under control at historically low levels; the domestic financial system remains sound; external financing consist mostly of medium- and long-term flows, and export volumes continue growing at significant rates despite the difficulties in the international scenario, and external solvency and liquidity are in a privileged position among all emerging economies. This set of fundamental variables underpins our conviction that the economy will move along a gradual recovery path over the next few quarters, similar to the course of the Asian economies that made the necessary adjustments in a vigorous and timely way to reestablish a stable growth path.

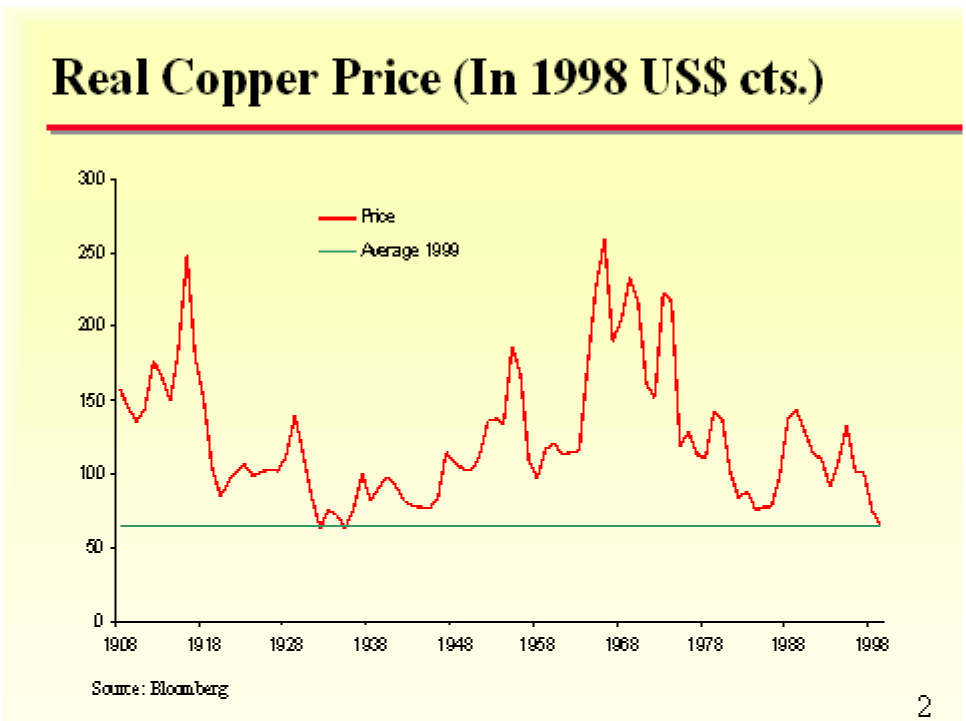
Nonetheless, it cannot be denied that the international crisis has meant significant costs for the Chilean economy. The main cost has been in terms of slower economic growth and substantial increase in unemployment. Efforts to stabilize the economy following the sharp external shock have aimed at minimizing this cost in the medium and long term. The policy measures adopted this year, will enable our country to quickly return to high growth rates, that will be sustained as international economic activity consolidates its recovery process.

II. International scenario

The current situation of the Chilean economy can be only understood by acknowledging the magnitude of the external shock it has had to confront. In 1998 and 1999, world economic growth, at about 2.5%, has been practically 2 percentage points below the average growth rate over the four years prior to the crisis; compared to this, in the Latin American crises of the 1980s, worldwide growth dropped back by just 1.2 percentage points. The greatest impacts of the current crisis were concentrated in the emerging economies of Asia, where average growth of 7% between 1990 and 1997 gave way to a GDP contraction of 7% in 1998. This went on to undermine the already weak Japanese economy; and Asia as a whole, which absorbs one third of our total exports, experienced a marked economic slowdown. Apart from this, growth in Latin America, which takes nearly 20% of Chile's exports, slowed from 5.2% in 1997 to 2.3% in 1998, and is projected to record negative rate of -0.5% in 1999.



The negative international panorama has also meant a steep fall in commodity prices, reflecting the currency depreciations in Asia and the lower level of world economic activity. The commodity price index fell by 22% from its June 1997 level, with the price of copper falling even more steeply (-27,5%).



As a result, the price of copper at the beginning of 1999 was at its lowest real level for over 60 years.

Financial Crises Compared

(annual average change %)

	1981	Ave. 82-83	1997	Ave.98-99
Coomodity Prices	-5,0	-3,9	-2,4	-11,4
Copper Price (US$c/lb.)	100,0	82,5	100,0	70,0

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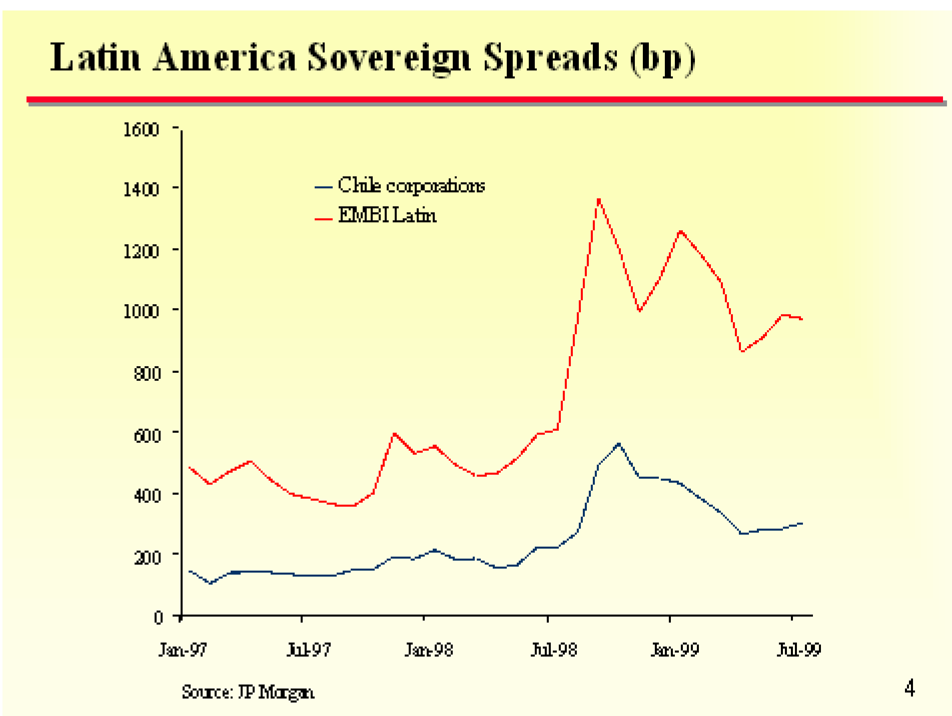
The international financial crisis we have been facing over the past two years has certainly been of large proportions. In terms of prices it has been more serious than the crisis of the 1980s: on that occasion commodity prices dropped by 13%, compared to their 24% fall over the last three years. The copper price went down by 17,5% in the 1982-83 cycle, compared to a 30% drop this time.

In addition to the impact in export prices, capital flows to emerging economies were cut drastically, and the risk premium paid by these economies were significantly increased, forcing adjustments to their current-account balances. In emerging Asia, the region most directly affected by the crisis, the overall current-account surplus grew from US$ 12 billion in 1997 to US$ 94 billion on average in 1998-99.



Moreover, the risk premium associated with emerging economies was raised significantly, with spreads rising from an average 450 basis points in 1997 to around 800 basis points in 1998, and over 1000 in the initial months of 1999.

III. Impact on the Chilean economy

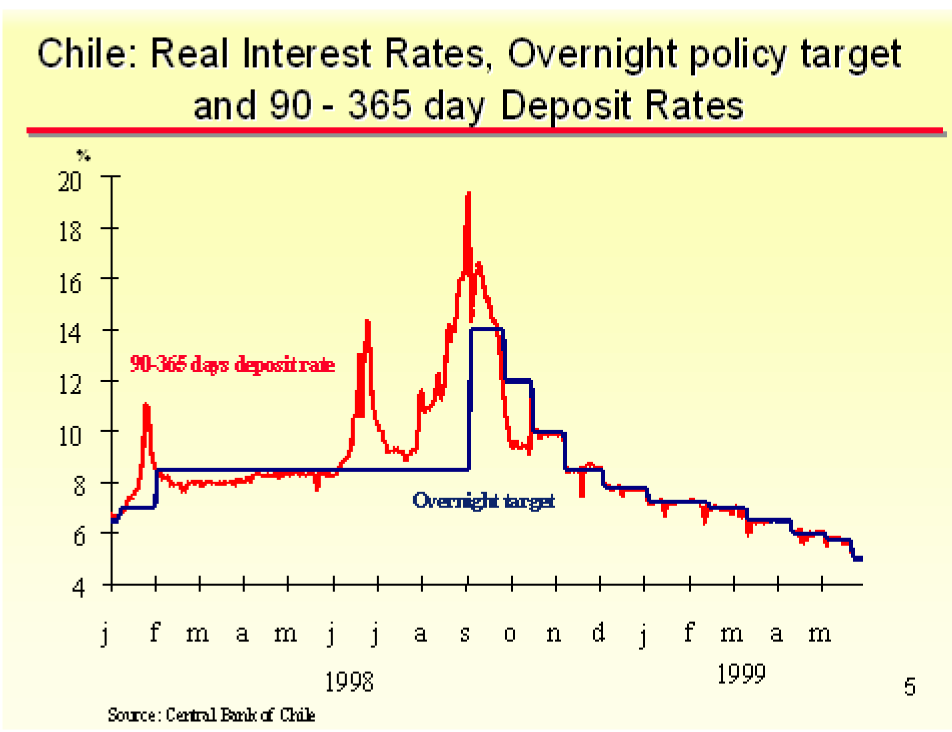
The global financial crisis has severely tested the capacity of our economy to navigate in turbulent and uncertain international economic waters. The slowdown in international economic activity has been reflected in a deterioration of our terms of trade, as a result of significant reductions in the prices of our export products, particularly copper and certain forestry products, which were in great demand in the region most affected by the crisis. In 1998 the fall in our export prices was partially offset by lower prices of oil and other products that we import. However, the terms of trade - the price of our exports relative to the price of our imports - fell by about 12% from its the average level in 1997, and this meant an estimated cost for the country of nearly US$ 2.2 billion, or about 3% of GDP. In the current year, an additional deterioration in terms of trade is expected to occur, estimated at 6% to 7%, in view of trends in the prices of copper and oil. The two consecutive reductions, accumulating 18% plus, constitute the biggest fall in the terms of trade since 1981-82, and has been strong enough to reduce them practically to their average level in 1982-83.

To complicate the situation still further, the net inflow of capital from abroad decreased from 9.4% of GDP in 1997 to about 4.3% of GDP in 1998. The external financing became insufficient in 1998, given that the current account deficit reached around 6% of GDP. At the same time, the spread charged on international financing to our country went up sharply, from 150 basis points in 1997 to 400 in 1998. Apart from these external factors, economic activity was also hurt by drought and the direct impact of this on electricity generation and traditional crops, together with an indirect impact on the rest of economic activity due to rationing and intermittent power cuts. These developments, which in the first half of this year have trimmed about 1 percentage point from the annual growth rate, had also served to generate a climate of uncertainty.

IV. Monetary and foreign exchange policy

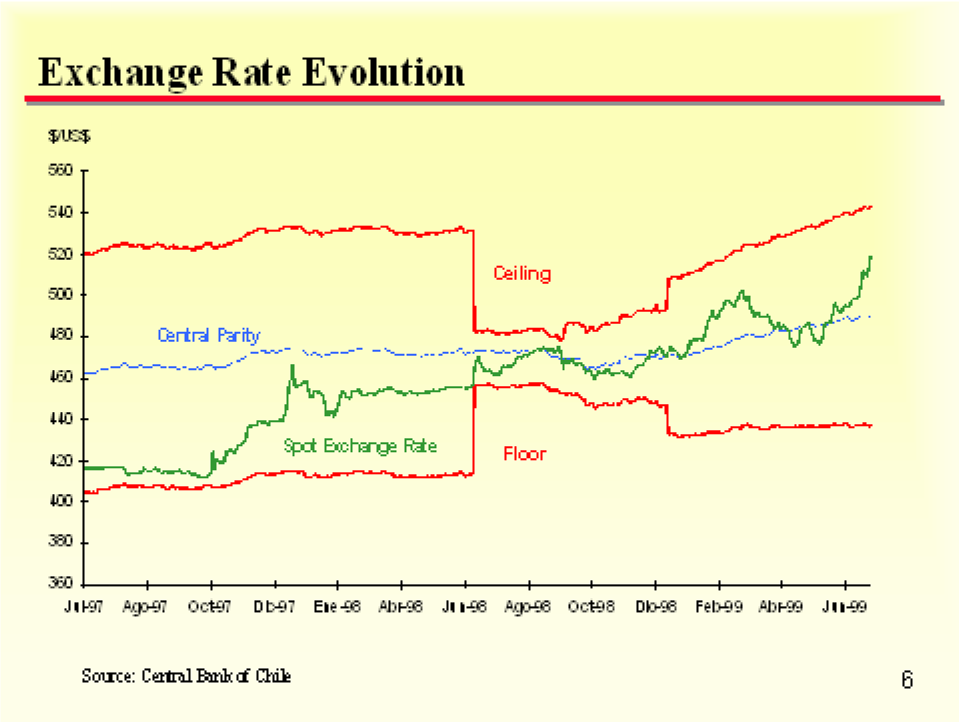
The severe deterioration in external conditions, which had been relatively favorable for Chile for over a decade, came at a time when domestic economic activity was growing strongly, as reflected in extremely rapid growth of domestic spending, and in a widening deficit on the current-account of our balance of payments. Thus, the combination of adverse shocks to the terms of trade and the capital account, and a clear over-expansion of domestic spending, pieced together a highly vulnerable scenario for the Chilean economy, which required resolute policy action.

The permanent goal of monetary policy should be price stability, which must be consistent with the maintenance of a bounded and reasonable current-account deficit, possibly no greater than 4% to 5% of GDP at trend prices. For this dual purpose the Central Bank does not set specific target values for the nominal exchange rate (apart from the limits of the currency band), but focuses monetary instruments so as to affect the course of aggregate spending. Control of aggregate spending favors a sustainable real depreciation of the peso, consistent with fundamental equilibrium. Given the level of sustainable aggregate spending, a higher saving rate enables a larger proportion of it to go to investment, thereby making it possible to sustain a faster growth rate. Monetary policy and macroeconomic policy in general have the tools to affect expenditure; but their possibilities for influencing the saving rate are very limited.



In 1998, monetary policy aimed, in a limited period of time, to reduce a current-account deficit that was threatening to breach the 7% threshold that is seen as setting off the Asian crisis. Respect for the economy's basic equilibria is a necessary condition for sustained medium- and long-term growth, and in these circumstances this calls for austere monetary and fiscal policies. During 1998 we raised interest rates and the Finance Ministry announced expenditure cuts to moderate the expansion of domestic demand and make this consistent with the maintenance of macroeconomic equilibrium. In addition, like other emerging economies, the interest rate was used to avoid a downward spiral in the value of our currency in the face of speculative pressures and abrupt changes in financial expectations. A rapid depreciation at this time endangered the inflation rate target, threatening a decade of sustained effort for defeating inflation. Accordingly, the Central Bank base rate was raised from 7% (real) in January 1998 to as high as 14% in September, where it stayed for a few weeks, with the average for the year rising to 9%.

As the adjustments objectives have been achieved and macroeconomic equilibria has been preserved, while the turbulences that affected financial and foreign exchange markets have dissipated, the Central Bank has gradually but steadfastly lowered the interest rate to its current level of 5%. This has been done to promote a lasting recovery of growth in a framework of macroeconomic stability.



Another area of concern, since the onset of the present crisis, has been the course of the nominal exchange rate. As has been the case throughout the present decade, the actions of the monetary authorities in the exchange rate domain have tried to recognize and respect the more permanent trends in the foreign-exchange market, while seeking to smooth out sharp movements that could give rise to speculative bubbles. The nominal exchange rate depreciated by about 20% from October 1997 to June 1999, while inflation has amounted to just 5.9% over the same period. The actions of the Central Bank have not sought to slow or restrain this trend, but to prevent an over-reaction in the markets in the face of a clear break from the previous exchange rate trend, which might bring with it negative consequences for inflation and financial variables.

In 1998 the Chilean economy was faced with very unfavorable conditions, so it was natural for there to be greater uncertainty about their consequences for the economy and about the orientation of policy in this context. If, in a period of uncertainty and excess spending, the Central Bank were to allow sharp exchange-rate adjustments, the new exchange rate that became established after the first devaluation may not be able to anchor market expectations, particularly if the devaluation were to be seen as an abandonment of the inflation target. Then it is perfectly possible that the initial devaluation would be seen as insufficient, so, with less credibility in monetary policy and no clear nominal anchor, further devaluation episodes would occur. Sooner or later, defense of the new parity with interest-rate hikes would be inevitable. In other words, if we had given way, ultimately not only would we have had to accept accelerating inflation but higher interest rates would have been required as well, and probably much higher rates in order to recover lost stability.

Moreover, at an initial stage, when the Chilean economy was showing clear signs of overheating, with domestic demand growing much faster than potential output and with very low unemployment, a large peso devaluation would have simply annihilated our decade-long efforts to reduce inflation to international levels. Worse still, it would have been ineffective in modifying the real exchange rate because the rise in the price level and its transmission through the widespread indexation mechanisms in our economy would have eroded any initial advantage. Finally, there can be no doubt that monetary policy, as a consequence of capital arbitrage, also has transitory effects on the nominal and real exchange rate, but these tend to reverse themselves over time as the real exchange rate returns towards its "equilibrium level". The quantitative importance of these effects may be large, but if the increase in the real exchange rate is only transitory, not only will this variable not have been altered but inflation will have accelerated. Export business develops on the basis of a stable and predictable real exchange rate that reflects the fundamental competitiveness of the economy.

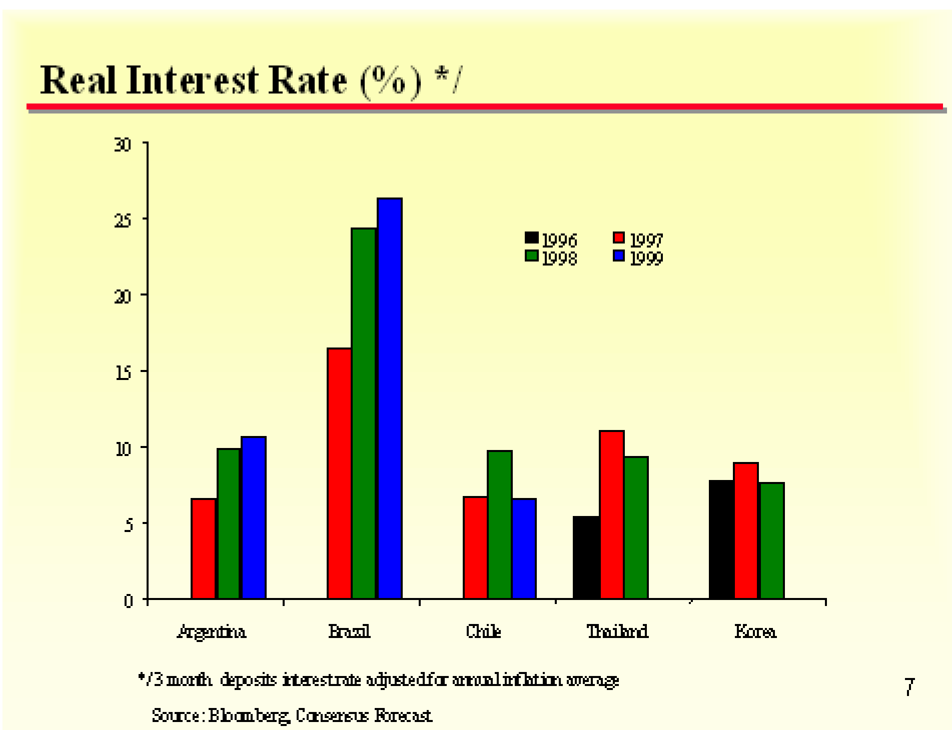
What I wish to emphasize is that movements in the nominal exchange rate, no matter how spectacular they may seem, do not guarantee permanent alterations in the real exchange rate unless they are accompanied by and reflect deeper changes in the real variables of the economy, such as spending, saving, real wages, productivity, external conditions or Government spending. Foreign-exchange policy can only be useful to complement an adjustment in this relative price when the fundamental conditions have been changed in the right direction, otherwise it ends up being useless when accelerating inflation neutralizes the initial increase in the real exchange rate. In addition, exchange-rate "activism" involves assuming the costs associated with an excessive accumulation of international reserves, which requires issuing domestic debt to sterilize it.

The Central Bank has made secure and steady progress towards increasingly flexible exchange-rate management, providing instruments of additional cover, relaxing the rules, simplifying procedures and creating the conditions for a more sophisticated and efficient management of our financial system. As the adjustment process set in, the fundamental conditions were modified and space for a real currency depreciation was gradually created. In addition, the difficulties involved in our firms' severe exposure to exchange-rate risk, arising from a long uninterrupted period of appreciation was overcame. All of this allowed for a greater variability in the exchange rate without risking macroeconomic and financial stability. Thus the Central Bank's exchange-rate policy facilitate flexibility in the nominal exchange rate so as to allow for a faster adjustment to the real exchange rate towards values that are consistent with economic fundamentals, giving flexibility to the nominal exchange rate, within an increasingly wide band.

V. Comparative position of emerging economies

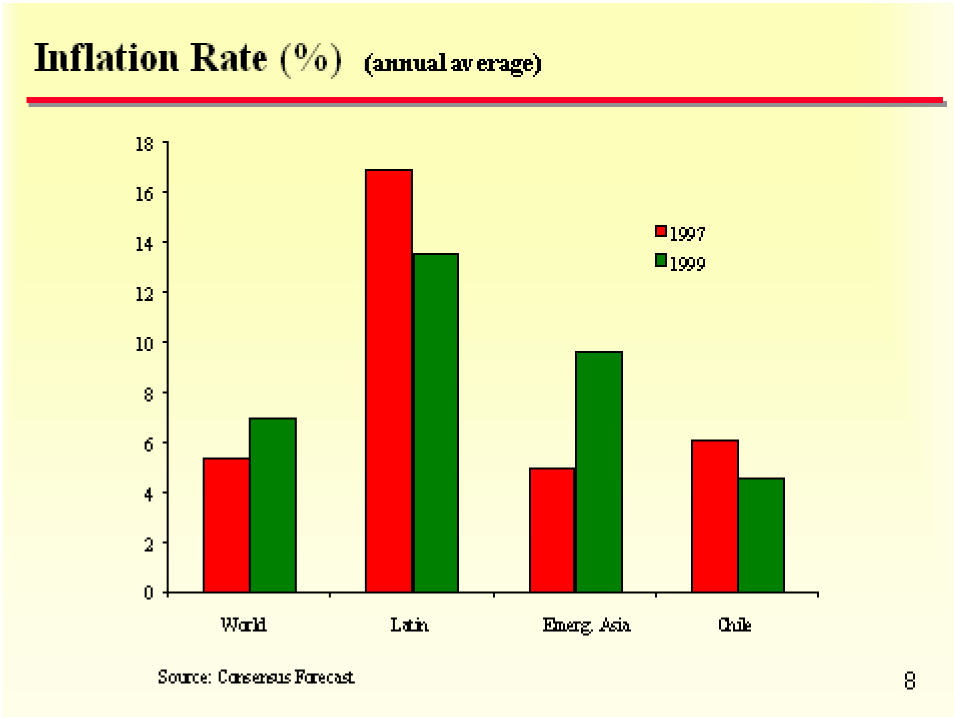
For the emerging economies of Asia and Latin America, the last two years of this century will be remembered as a specially difficult period: one of large adjustments, financial instability, slower growth, high unemployment and a climate of uncertainty making it difficult to take policy decisions. Unlike Chile, in the other emerging economies, especially in Asia, it was necessary to make significant reforms to the financial system and in certain cases severe fiscal adjustments also.

In general during the second half of 1997, the Asian economies suffered strong speculative attacks on their currencies, motivated by their large current-account deficits and weak external financing. This, together with fragile financial systems, rigid exchange-rate rules and political instability, made it difficult to successfully defend the prevailing parities. Sharp reductions in international reserves forced many countries to allow their currencies to float, and this meant steep depreciations. Contagion did not take long to spread through the emerging economies, which suffered sharp currency depreciations, significant interest-rate hikes, and falling asset prices. Given the prevailing uncertainty, exchange rate pressures did not cease and the initial depreciations were deemed insufficient.

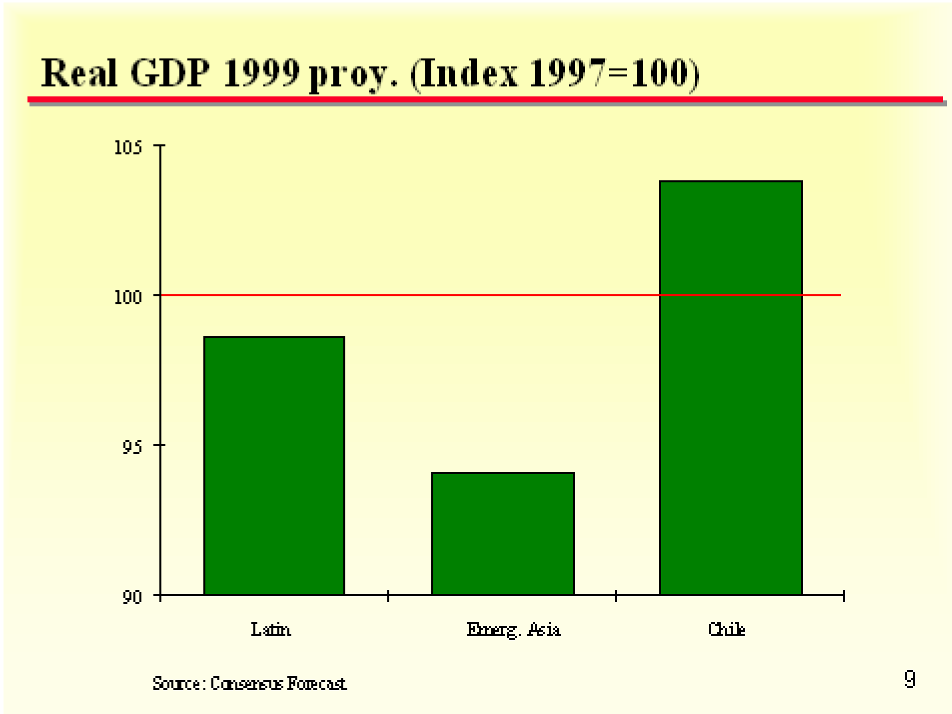


To detain the free fall in the value of their currencies and make the necessary adjustments to domestic demand, the authorities made intensive use of monetary policy, taking real interest rates to the high levels of adjustment years; this happened in Thailand

and Korea and is still the case in Brazil. Of all Latin American countries, Brazil had to withstand the strongest attacks on its currency and was forced to raise its real interest to incomparably high levels. In Argentina real interest rates are not a policy tool, but there the market has raised the rates in two consecutive years to levels above those prevailing in countries which actively use interest rates as an adjustment tool. Chile raised real rates comparably to the Asian countries in their adjustment phase, but we have been able to bring rates down again more quickly.



The effect of devaluations did not take long to show through in prices. The local currency inflation rate for the economies of South East Asia rose from 5% in 1997 to 23% in 1998, which meant that, given the magnitude of the nominal devaluation, the real exchange rate made only limited gains. The average real depreciation in 1998 compared to January 1997 was little more than 20% for most of the Asian economies, compared to an average nominal devaluation of 60%. In Latin America inflation has come down, but from high levels, and in countries like Mexico there has been a real appreciation of 15% over the last two years. In Chile, inflation has continued to fall, and the exchange rate has gradually depreciated by slightly over 20% from its January 1997 level, while prices have gone up by 11.4% over the same period.



When the impact on GDP growth in each country is analyzed, it can be seen that the costs for Chile have been comparatively minor. In 1999, output in Chile will exceed in about 4% that of 1997; this is bettered by Mexico, which has a free trade agreement with United States, the world economy's only engine in 1998, but not by the Latin American countries average. Output in the emerging economies of Asia as whole will be clearly lower in 1999 than that of 1997.

Country-Risk Indicators

	Jul-98	Oct-98	Jan-99	Apr-99
Latin America				
Argentina	37	35	41	42
Brazil	59	69	63	72
Chile	21	26	29	27
Mexico	46	49	39	46
Asia				
China	37	39	41	41
Korea	47	49	28	26
Thailand	47	47	33	37

Source: JP Morgan

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At the present time, indicators of the solvency and vulnerability of the Chilean economy reveal a strong and healthy condition, which will make it possible to quickly resume the high growth path that our economy has followed throughout the 1990s. If we compare risk indicators for the Chilean economy today, with those of other emerging economies, our country and Korea are in the best position. This may not be a new conclusion, for it is well known that Chile's risk classification of has been the best in Latin America for several years. On this occasion, however, there is an additional element: we now have a better relative risk position than most of Asian emerging economies, and that was not the case in 1997. Moreover, we have continued to improve our position relative to the rest of Latin America. With respect to the situation in June 1998, the adjustment policies adopted have enabled us to improve our solvency position through a reduction in the current-account deficit, our solid external position and the maintenance of macroeconomic equilibrium.

Similar conclusions can also be obtained by comparing the ratio of short term external financing requirements to net international reserves.

Short Term Financial Requirements over Reserves (*)

(in percent)

	1997	1998	Apr-99
Latin America			
Argentina	163	163	152
Brazil	182	216	179
Chile	64	51	35
Mexico	295	251	181
Asia			
Korea	264	195	75
Malasia	95	52	23
Thailand	176	109	85

(*) Include Current Account Deficit, Short Term Debt and amortizations of medium and long term debt

Source: JP Morgan

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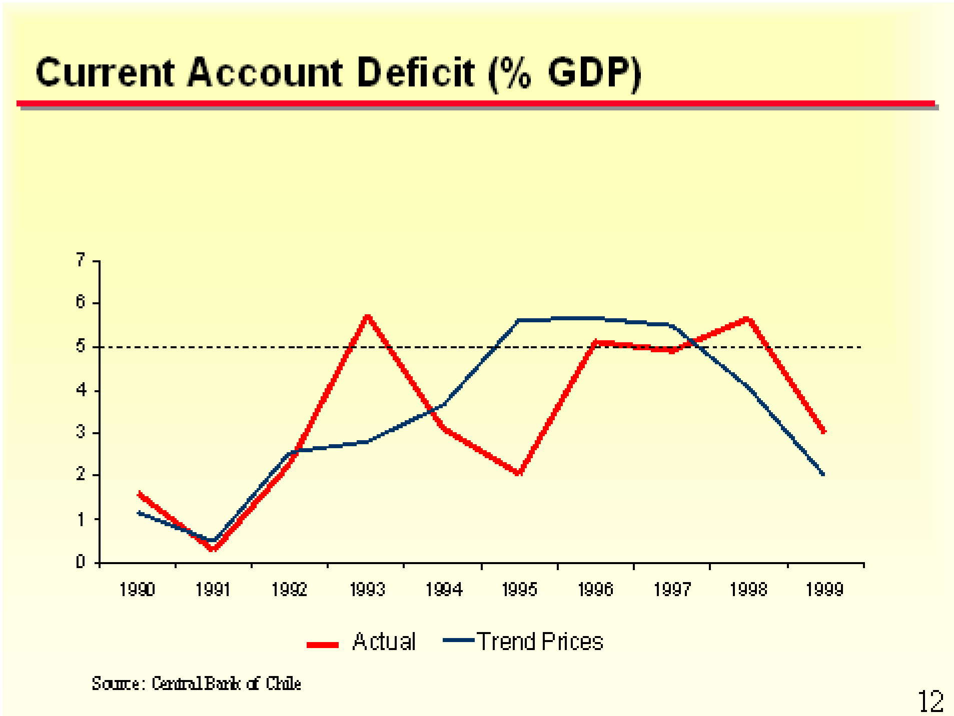
For the year 2000, the short term external financing requirements are projected at moderated values, US$ 4,6 billions, slightly higher than the US$ 4,2 billions registered in 1999, but consistent with a strong and highly liquid external position.

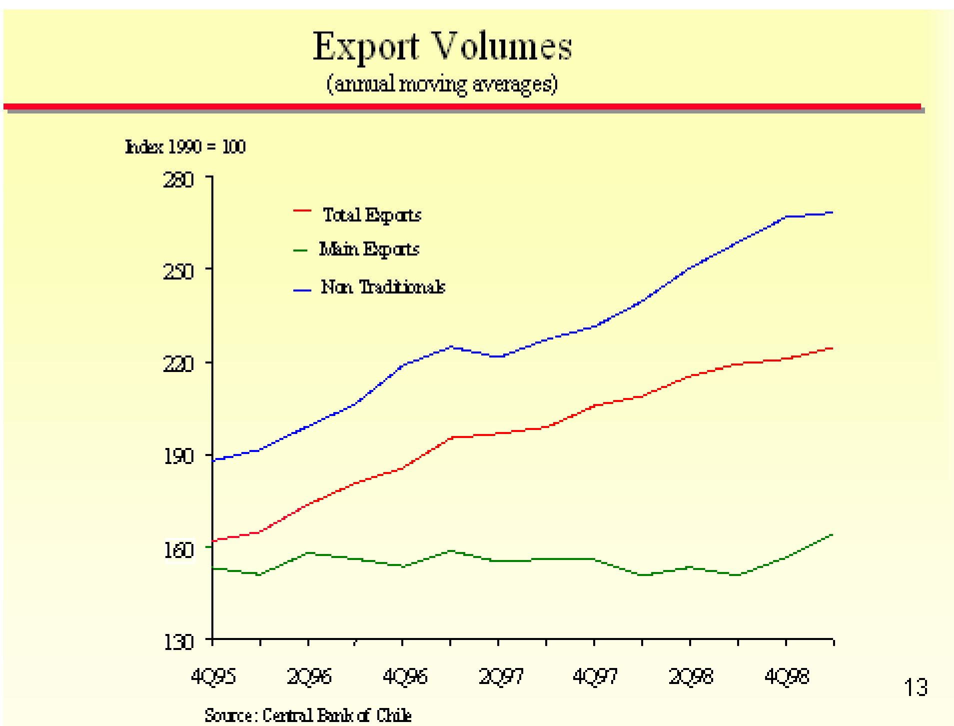
VI Recent trends and prospects

The Chilean economy's adjustment program has produced the desired results, including a moderation of domestic spending, control of the current-account deficit of the balance of payments and reduction of inflation in consistency with the Central Bank targets. More important the risks currently facing the Chilean economy are bounded. The main threats of international financial collapse seem to be over, and the economies which needed to make exchange-rate adjustments or spending cuts have mostly done so. The IMF projects world economic growth for 1999 at a similar rate to that of 1998, but growth in emerging Asia will be much stronger, and Japan seems to be starting to climb out of its recession. Although risks are always present -- interest rates are rising in the United States, a large country in Asia still has very depressed domestic demand and deflation, and a large country in Latin America still has a long way to go to adjust its fiscal debt position to levels that can be financed in the long run--, significant progress has been made and the balance for the world economy is positive. This has been reflected in increases in stock markets around the world, in commodity prices and reductions in emerging countries sovereign spreads, from the levels registered towards the end of 1998 and the firs months of 1999.

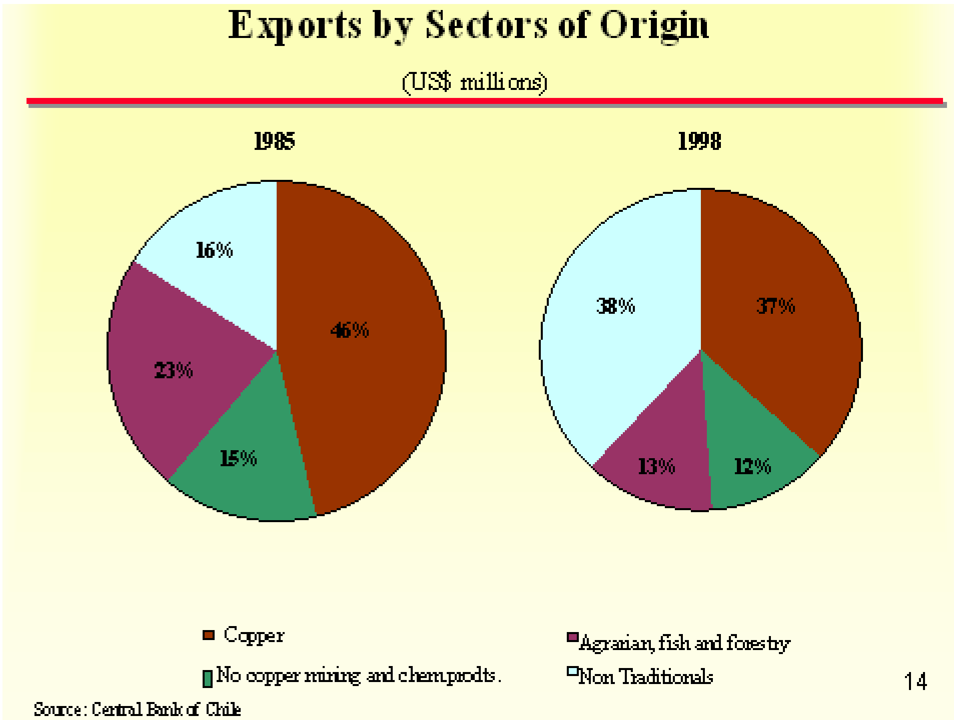
The Chilean economy is ready to resume the sustained growth path it has been following during the 1990s although at a somewhat lower rate. The current-account deficit will end 1999 at around 3% of GDP, despite the very low level of the terms of trade, and this gives space for growth in the coming years. The deficit is substantially smaller than it would have been in the absence of the adjustment, and it is a reflection of the major effort the country has made to moderate domestic demand in an extremely complex international scenario. The authorities have sought to safeguard the stability of external payments by maintaining a trend deficit in the current account below 5% of GDP, a level widely considered to be consistent with the medium- and long-run external financing capacity of the Chilean economy.



Concern for the current-account deficit needs to be evaluated from a longer-term perspective, looking beyond transitory fluctuations in our terms of trade. The high volatility of our country's terms of trade means that there may be temporary factors that explain variations in the current-account deficit. To distinguish transitory factors from more permanent ones, an underlying current-account deficit has been constructed, using a trend value for the terms of trade, level that is projected to prevail on average over the next five years. For this purpose the prices of import and export goods were normalized in dollars, as were other variables with transitory components; the trend price of Brent crude was projected at US$ 16 per barrel , and the price of copper at US$ 0.90 per pound. The result of the exercise is that, at trend prices, the current-account balance has breached the reference level of 5% of GDP only very briefly (1995-1997), and even then only marginally. Although the underlying deficit, or the deficit measured at trend prices, is high, it is not at extreme levels, and if normal terms of trade conditions had prevailed it would have required only minor adjustment. In 1998 and 1999, there was a sharp deterioration of the terms of trade, but the current account deficit only grew to 6.2% of GDP in 1998, however the adjustment brought it back down to about 3% in 1999. At trend prices, however, these deficits come down to slightly over 4% of GDP in 1998 and between 2% and 3% of GDP in 1999.



Although external demand and export prices have fallen significantly, export volumes have continued to grow, albeit with some differences between sectors. The effect of the external crisis has been tempered by a geographical reorientation of our exports; in 1998, the volume of exports sent to Asia shrank by about 11%, while the volume sent to the rest of the world grew by 17% compared to 1997. Results for 1998 indicate that total volume exported increased by 6.2% while the volume of non-traditional exports grew by 12.2%. The lower volume expansion was reported by the non-copper principal exports, including fish meal, certain woods and wood products, and methanol. In the case fish meal, exports were affected by a fall in the fish bio-mass and the fish average size, caused by changes in the weather pattern. In the case of wood products and methanol exports, the declined is associated to the concentration of demand, in Asia and Brazil, respectively.

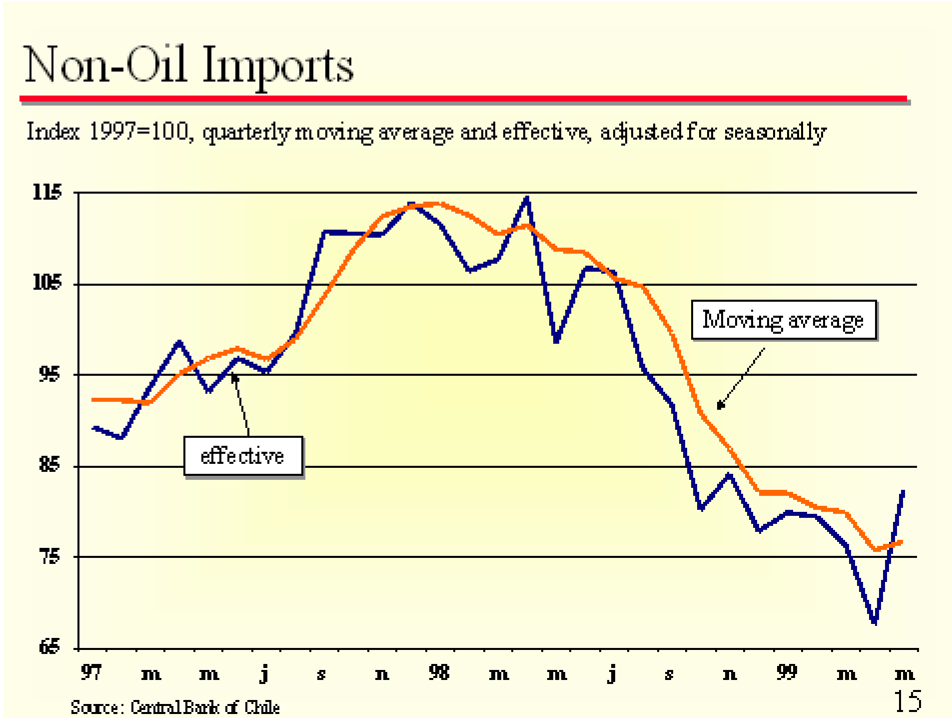


Over the past decade our exports have not only shown sustained growth at a faster rate than GDP, but they also have had sufficient flexibility to redirect supply to markets offering the best conditions. In addition, Chilean exports have slowly become more diversified as non traditional exports are the fastest growing group, gaining export share from 16% in 1985 to 38% in 1998. At the same time, mining exports, including copper loss participation from 61% in 1985 to 49% in 1998.

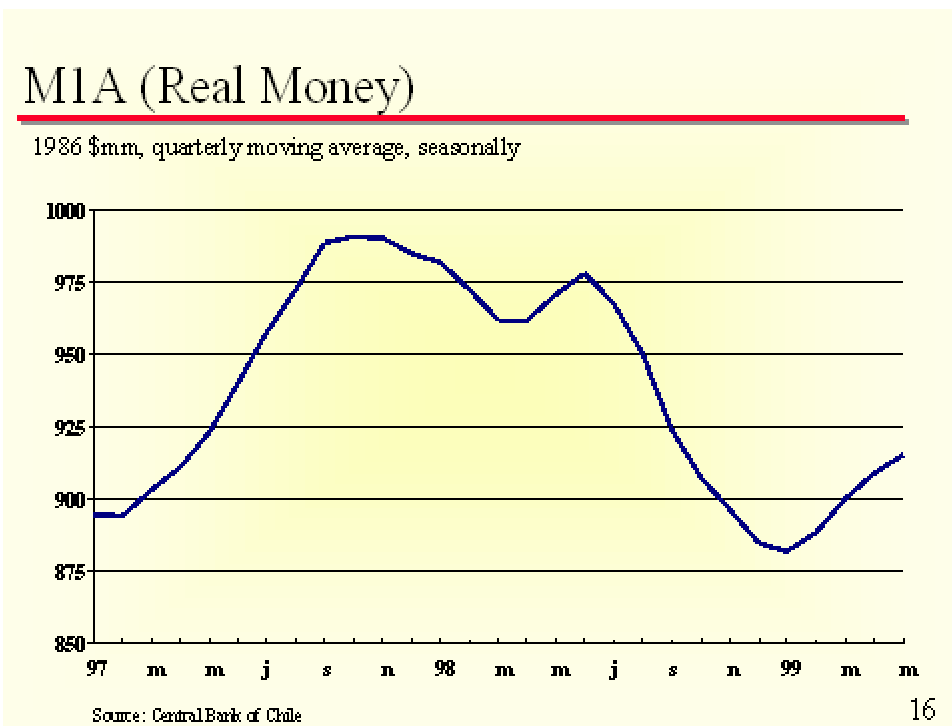
Looking to the future, and assuming no major changes in the international situation, it will not be necessary to continue reducing the current-account deficit, and this will basically mean there will be space for GDP to grow and for spending and imports to expand at a pace determined by the growth of exports. The expected trend of our exports will generate, in stable external conditions, reasonably ample spaces for the economy to begin to approach its habitual growth rate as from the second half of 1999, without jeopardizing stability. Our estimates suggest that export volumes will grow by about 9.5% in 1999, and total exports will amount to an estimated US$ 15.5 billion in the year. This is based on an acceleration of copper shipments as new projects mature, renewed growth in export volumes in traditional products such as fruit, wood, wood pulp and methanol due to economic recovery in Asia, and growth on the order of 6% among non-traditional exports. As regards regional distribution, during the first quarter of the year exports to Asia went up by 8%, giving signs about the recovery of demand from that region.

In addition, following the adjustment, which was as much costly as it was necessary, country-risk indicators have come down to very favorable levels, and this will make it possible to access the necessary external financing for the current-account at reasonable interest rate. Furthermore, our country currently enjoys a privileged position as regards international reserves, compared to other economies of the region, with a stock that covers nearly eleven months' of imports and over 50% of M2. External debt, meanwhile, represents about 40% of GDP, and when international reserves are deducted this is equivalent to slightly over one year's exports. All these figures show that our short-run external funding needs are perfectly achievable without having to use up foreign exchange reserves, and this also holds in more complex external-financing circumstances than the present ones. In this regard, it is worth stressing the importance of having maintained a positive country-risk evaluation with the specialist agencies, for this puts us in a privileged position among the emerging economy group to obtain financing on international financial markets.

As regards economic activity, a look at the recent trend of activity and expenditure indicators (monetary aggregates, industrial production, commercial sales, real-estate sales and non-petroleum imports) all show a gradual recovery over the first four months of 1999.



Non-oil imports recovered in May from their April levels, in keeping with the results of recent months: at the margin, one does not see a continuing downward trend, nor yet is there a very marked recovery.



Indicators of final expenditure also are showing signs of recovery. The real money supply M1A has picked up gradually over recent months and, in particular, the May figures are up from those of April.

1999-2000 Macroeconomic Forecasts

	1998 Effect.	1999 Forecast	2000 Forecast
	(Percentage change)		
1. Gross Domestic Product	3,4	±0,5	4,5/5,5
2. Consumer Price-Index	4,7	±4,3	*
3. Current Account Deficit (% GDP)	6,2	3,0/3,5	4,0/4,5

*/ Inflation target for year 2000 will be presented in the Annual Report to the Senate, next Sept.

Source: Central Bank of Chile

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Recently the Central Bank has adjusted its projections for this year and the next. The current-account deficit is now estimated at between US$ 2 billion and US$ 2.5 billion (3% + of GDP), whereas trend inflation is projected to better the target set for the end of the year. These projections are consistent with an economy that is recovering, but more slowly than had been anticipated. GDP growth is projected at the present time at around 0.5% for 1999 as whole.

1999-2000 Macroeconomic Forecasts

	1998 Effect.	1999 Forecast	2000 Forecast.
	(US$ mm)		
4. Current Account Balance	-4,5	-2,0/-2,5	-3,0/-3,5
5. Trade Balance	-2,5	-0,5/-1,0	-1,0/-1,5
	(percentage change)		
6. Volume Exports. (Merchds)	6,3	9,6	5,4
a) Copper	6,7	12,4	4,0
b) Non Copper	6,0	8,0	6,2
7. Terms of Trade	-12,1	-6,5	2,0
	(US$ cts. /lb)		
8. Copper Price	75,1	65,0	70,0

Source: Central Bank of Chile

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Next year inflation will continue its downward course, and the current-account deficit could be between 4% and 4.5% of GDP, with GDP growth recovering to a range of between 4.5% and 5.5%.

The Chilean economy has started to recover. The recently announced measures will give new impulse to a recovery that was seen as slower than desirable. In brief, the disproportionate increases in spending that the Chilean economy was experiencing in late 1997 and early 1998 have been overcome, the current-account deficit has been reduced, and inflation is on target. The adjustment generated a slowdown in growth which has created the room for monetary policy to become more expansionary. The way is now clear to resume sustained economic growth, and, unlike previous crisis episodes, the interruption has been brief and has not meant structural damage despite the powerful external shock. Our economy is built on very strong foundations: low inflation, a solid external sector and a financial system that stands out for its efficiency and solvency. The reasonable and credible macroeconomic policies currently in place help to strengthen the foundations for sustained growth in the Chilean economy, which will once again come to be seen as highly dynamic and competitive in the international arena.