Recent Macroeconomic Developments in Chile: Quarterly Review[1]

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Hello everyone. Thanks for dialing in and giving me the opportunity to say a few words about recent macroeconomic developments in the Chilean economy. Heinz will then address progress on the modernization of the state, transparency and the promotion of growth; and the recent fiscal adjustment and tax reform, perhaps the most important macroeconomic development during the quarter.

Before getting into the substance, let me remind you that, in many respects, the climate in the place where you are now may be very different from here in Santiago right now. In particular, for those of you in the Northern Hemisphere, while you may be enjoying or suffering summer time, it undoubtedly is winter time over here. For this weekend, while many of you might be planning to go to the beach, some of us around here are thinking about going skiing.

I mention these great differences in climate and weekend plans because, in sharp contrast, the economic climate may not be overly different where you are now and here where we are. As you know, the world economy has been growing below trend for a while, and the Chilean economy is not an exception, having grown 2.1% last year, following growth rates of 4.2% in 2000 and 3.1% in 2001. Being small and very open, it would be illusory to expect that the Chilean economy could insulate its business activities from economic developments abroad.

Having said this, I think it is important to highlight that the Chilean economy has been adjusting and responding to the world economic slowdown much better than it did in the past under similar adverse external situations. In the 1930s, mid seventies, early eighties, and even as recently as in the late nineties, deteriorated external conditions inevitably led to recessions. In contrast, while the growth rates since 2000 I just mentioned are not spectacular, they are all positive, not only in absolute terms, but also after adjusting for population growth.

Of course, the improved cyclical performance has not been achieved by chance. There can be little doubt that, in addition to the contribution made by the strong fundamentals that the Chilean economy has built since the mid seventies, it owes a lot to the changes in the macroeconomic framework since 1999. The floating of the exchange rate, the consolidation

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of the inflation targeting regime, and the adoption of the fiscal rule based on the attainment of a structural surplus of one percent of GDP, are all elements that have significantly improved the resilience of the economy. These elements add to the existing solid foundations a degree of built-in flexibility that helps dampen the effects of adverse conditions. Thanks to an environment of strong credibility, it has been possible to have a strong monetary stimulus and operate automatic stabilizers from the fiscal side.

Having described this general context, what have been some of the main macroeconomic developments during the last quarter? In the remainder of my remarks I will focus mostly on short and medium term growth prospects, and then briefly refer to inflation.

On growth, one of the developments that I can report is that the national accounts data released in May confirmed the assessment we had made in the last review that growth during the first quarter of 2003 had continued the trend toward faster growth observed last year. Indeed, output growth during the first quarter was 3.5% relative to the same quarter of the previous year, while demand growth in the same period was very similar, at 3.4%.

Another development to report is that, related to the sharp slowdown of the world economy in the second quarter of this year, we have some evidence that during the second quarter the pick up in growth lost some steam. This is revealed in particular by the monthly indicator of economic activity, Imacec, which showed growth rates of 2.7% and 2.5% in the twelve month period ended in April and May, respectively. However, the labor market continues to show rapid employment growth, of 3.1% in April and 4% in May. Since, in addition, sectoral data provides mixed signals, the lower than expected growth in recent months does not appear enough reason yet to justify a revision of projections.

Looking ahead, in turn, if demand and output growth in the US and the rest of the world picks up in the second half of the year, as expected by most analysts, growth rates in Chile are also likely to pick up. In addition to the effect of faster world growth on Chilean export prices and quantities and consumer confidence, the recovery will be aided by quite favorable financial conditions. This includes domestic interest rates that are the lowest levels on the books, at least since interest rates were liberalized in the mid seventies; a substantial increase in stock prices; and sovereign and corporate spreads that have continued to fall and were completely unaffected by stress tests such as those of the Corfo Inverlink affair or the financial challenges faced by Enersis, the electricity conglomerate that recently successfully completed a round of recapitalization. It also includes a real exchange rate that, despite some fluctuations during the period and a bilateral appreciation of the peso relative to the dollar, has continued at a historically depreciated level, partly a result of a depreciation of the peso relative to the Brazilian real and the Argentinean peso.

As a result of these developments, since the last quarterly review, in April, our expectation that this year's output growth will be larger than last year has consolidated. As forecasted in the last Central Bank Monetary Policy Report issued in May, annual growth in 2003 will probably be between 3 and 4%, although with a downside risk. In addition, there are now also good reasons to expect that if the world economy returns to trend growth, next year's growth will accelerate further, probably to a number above 4%. The Central Bank will update its forecasts in its September Monetary Policy Report.

Looking beyond 2004, it is hard to make forecasts. However, it is uncontroversial to say that Chile is well positioned to resume a growth rate faster than in the recent past. First, Chile's institutions continue to be very well evaluated, as assessed by independent observers. For instance, in May the Governance Group of the World Bank Institute published its latest biannual research on Governance Indicators, in which they examine indicators for 199 countries and territories. They again ranked Chile 19th on "Control of Corruption," above countries such as Spain (21) and France (22) and close to the average of OECD countries. Also, last week, the Fraser Institute released its annual report on Economic Freedom. The report ranks Chile number 20 among 123 countries, in the same position as Germany and above all other developing countries, excluding Oman and United Arab Emirates, two rich oil exporters. In addition, in the latest report by the Economist Intelligence Unit on the business environment in 60 countries, Chile appears ranked number 18, two positions above the previous report.

Second, additional ongoing reform efforts are likely to contribute further to improve growth prospect. In particular, the recent trade agreement with the EU and the progress with a Free Trade Agreement with the US improve the access of Chilean exports to the two largest markets in the world. On this, and despite speculation that Chile's position on the war with Iraq would hurt the prospects for rapid approval of the trade agreement with the US in the American Congress, reports in the last few weeks suggest that the approval may come much faster than expected and that on January 1st 2004 the trade agreement will indeed enter into force. Heinz will refer to other reform initiatives that are also likely to contribute to resume faster growth in the medium term.

And third, it is worth noting that the fixed investment rate remains at 22% of GDP, despite low growth. With an external current account deficit of 1% of GDP there is still plenty of room for this number to increase in the upturn of the cycle. Moreover, in the upturn, fiscal savings should also increase, allowing for still more investment. All this, together with the productivity gains that will arise from reforms, provides a solid base for potential output to continue to expand at higher rates.

Before concluding, I would like to briefly mention what has happened with inflation. Here, the main development since our last review has been that our forecast that inflation would quickly return to the target band between 2 and 4% was fully validated. Indeed, following the exceptional figure of 4.5% annual inflation in the twelve month period ending in March, ignited by the temporary increase the price of oil and its derivatives previous to the resolution of the conflict with Iraq, annual inflation fell to 4.0, 3.5 and 3.6% in the following months.

Looking ahead, we expect inflation to fluctuate around the center of the band, with the increase in the VAT planned for October from 18% to 19% having a limited and transitory effect. Of course, the CB stands ready to react to news in order to ensure that forecasted inflation remains consistent with the target. In particular, if the inflation forecast were to increase, the monetary stimulus will have to be reduced.

To conclude, while there are signs that the strength of the recovery during the second quarter moderated somewhat, the trend toward faster growth rates is likely to continue during the second half of the year and next year. This trend will be aided by the expected recovery of the world economy, led by the US, the recent trade agreements, and favorable financial conditions. Of course, in the case of a delay in the pick-up of world growth, Chile's growth rate may suffer somewhat relative to the forecasts. The macroeconomic framework, however, will help dampen the effects of such an alternative growth scenario, as well as maintain price and financial stability.