Chile Since the 1980s

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Outline

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  - Second Generation Reforms: 1984-1997
  - Reforms in the aftermath of the Asian Crisis

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I. Economic reforms and institutional buildup in Chile

Economic reforms and institutional buildup in Chile: 1974-81

- By the early 1970s Chile was in a sorry situation:
  - Inflation was high;
  - Foreign reserves had vanished;
  - Import tariffs were high and there were widespread price controls
- Thirty years of lax fiscal and monetary policies and increasing government intervention had created an unstable, closed and inefficient economy.
- Being Chile a very small economy, the resource allocation and welfare costs of the isolation from foreign competition were very high.

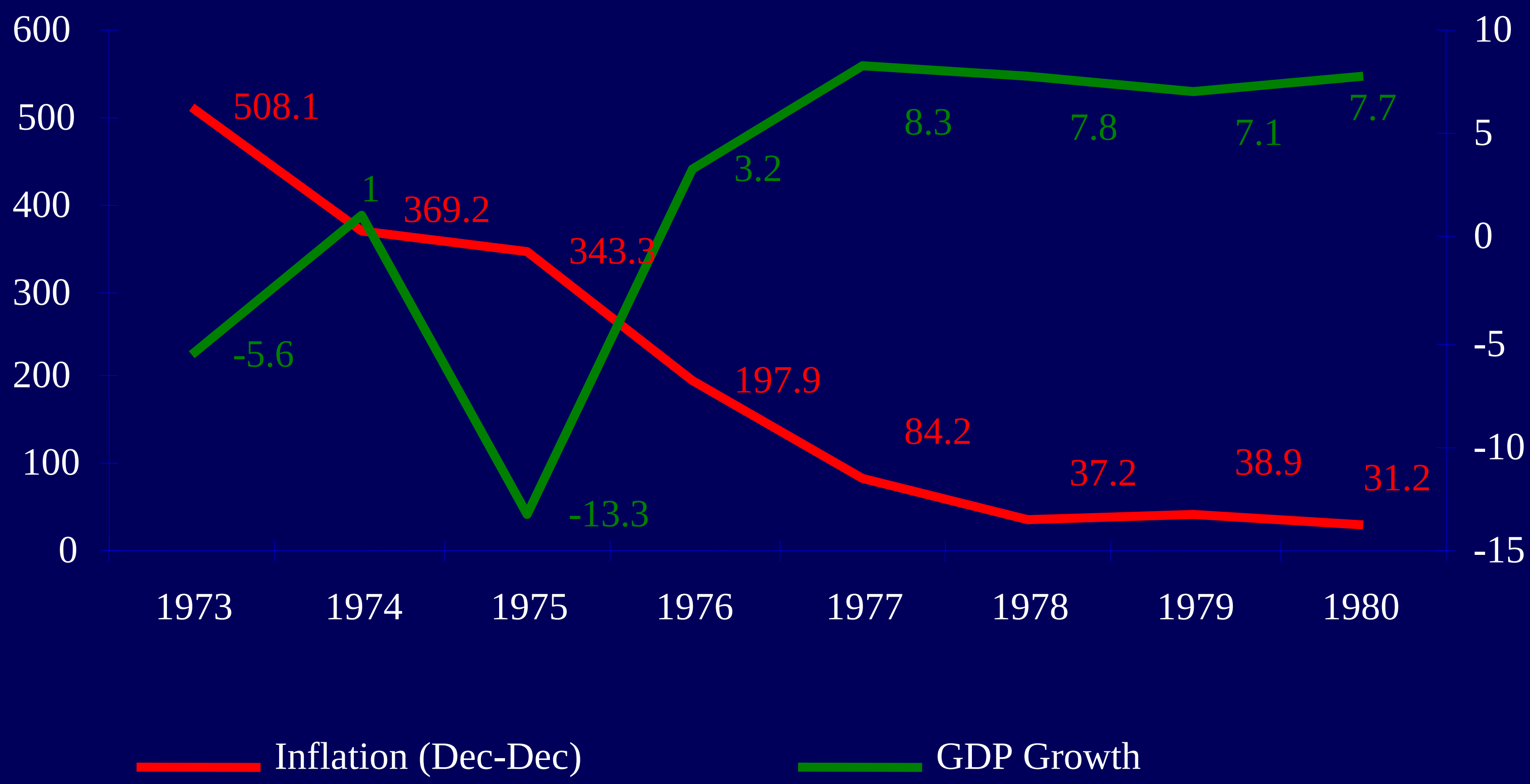
Economic reforms and institutional buildup in Chile: 1974-81

- Chile's economic transformation was initiated in 1974 and has continued up to today.
- Fiscal adjustment: the fiscal balance reached a deficit of 30% of GDP in 1973 and a surplus in 1976.
  - Tax reform: VAT was introduced in 1975.
  - There were major cuts in subsidies to unprofitable businesses.
  - SOEs and government owned banks were privatized or returned to previous owners.

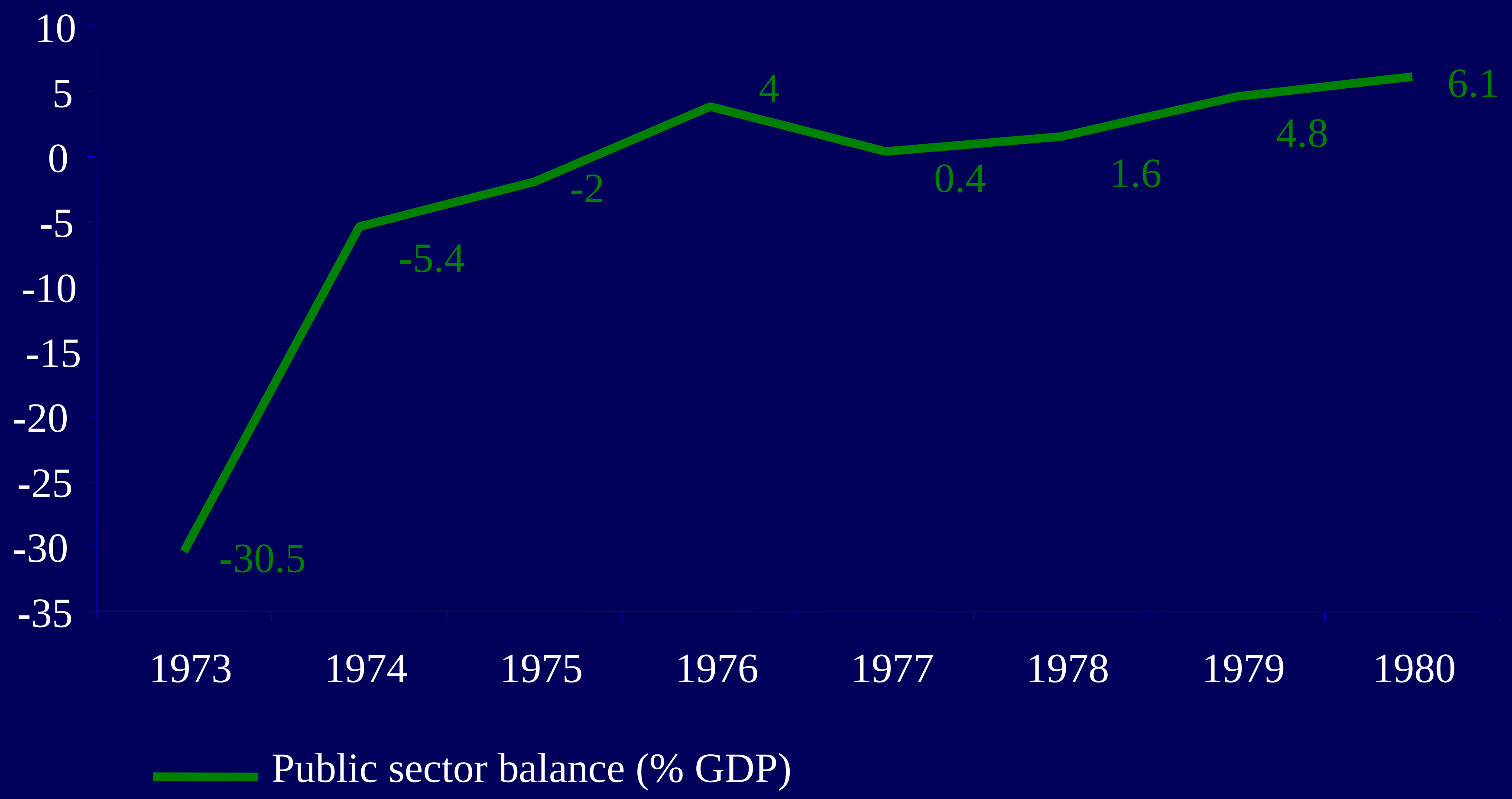
Economic reforms and institutional buildup in Chile: 1974-81

- And more:
  - Trade reform: non-tariff barriers were lifted and tariffs cut unilaterally to reach 10% flat in 1979.
  - Previously controlled prices and interest rates were liberalized.
  - Capital account restrictions were partly lifted while exchange rates were unified.
  - Exchange rate policy moved from a crawling peg to a fixed exchange rate in 1979.
- The stabilization policies and the move towards a market economy allowed a quick recovery.
- The quick recovery along with large capital inflows raised expectations, leading to large CAD.

Chile's Economic Performance: 1973-1980



Chile's Economic Performance: 1973-1980



Economic reforms and institutional buildup in Chile: 1974-81

- But the regulatory and supervisory frameworks of the banking system were not upgraded fast enough, exacerbating moral hazard problems in banking.
- The above led to highly concentrated portfolios, over-borrowing and large exchange rate exposures in the corporate and household sectors.
- The increase in international interest rates and the dollar appreciation of the early 1980s, along with backward indexation of wages, caused major imbalances that led to a deep crisis.

Economic reforms and institutional buildup in Chile: 1984-97

- The 1982-83 crisis uncovered major regulatory shortcomings and triggered a revision of several institutions, in particular:
  - A new banking law was passed in 1986, granting more powers to the regulatory entities and imposing limits to connected lending by banks.
  - Other bank regulations–e.g., asset rating system and capital-asset ratio–were updated to match international standards (i.e., BASEL Accord).
  - A new tax law (1984) was enacted providing strong incentives to save and invest –for instance, by eliminating double taxation on dividends.

Economic reforms and institutional buildup in Chile: 1984-97

- In addition:
  - A new bankruptcy law, expediting bankruptcy proceedings, was enacted.
  - Utilities, banks (taken over after the crisis) and other SOEs were privatized—the SOEs share in GDP fell from 24% in 1983, to 13% in 1989.
  - New antitrust rules were put in place.
  - Competition was introduced in telecommunications.
  - And the private sector was allowed to participate in infrastructure development through BOT concessions.

Economic reforms and institutional buildup in Chile: 1984-97

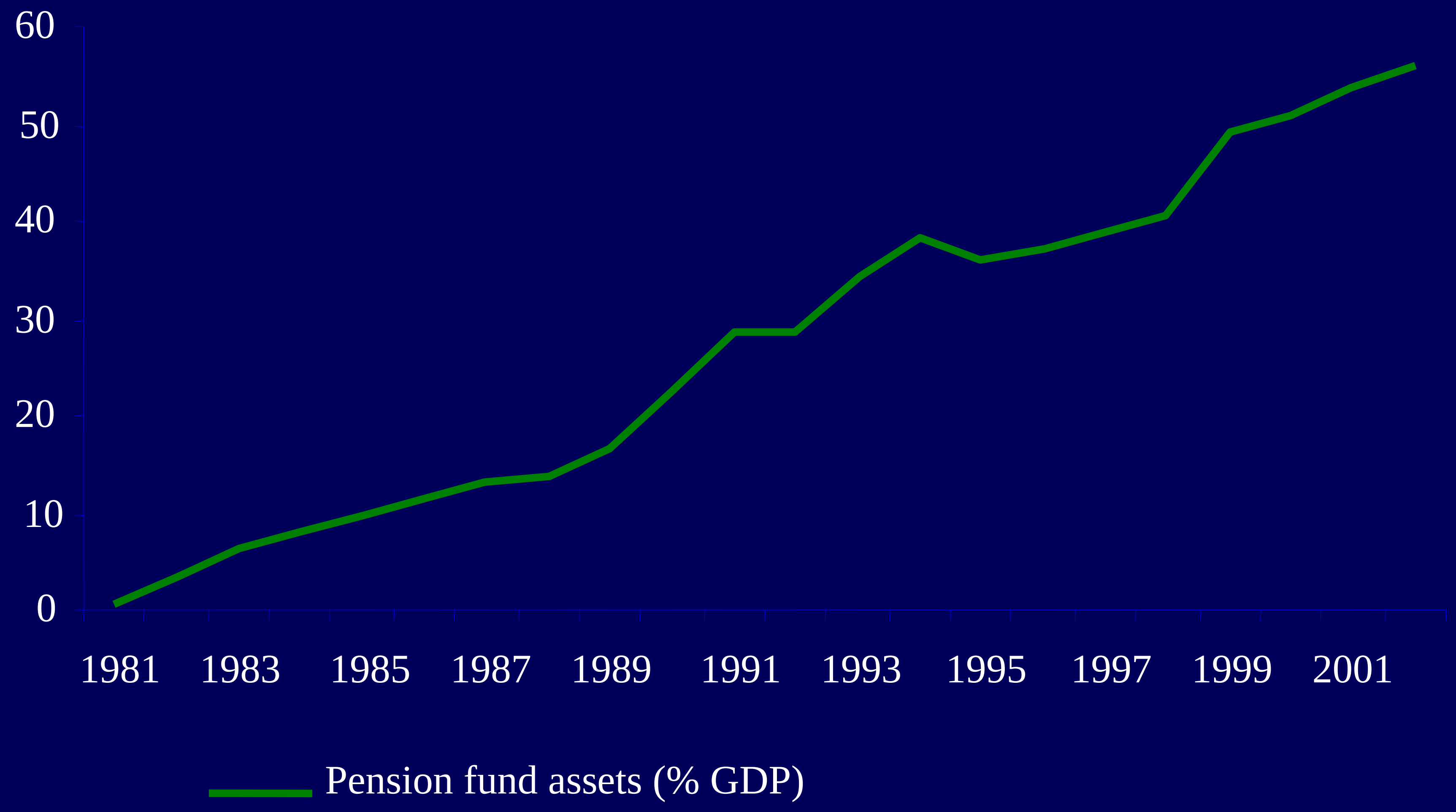
Two prior institutional reforms played a major role during this period:

- A new constitution had been enacted in 1980:
  - It set the timetable for the transition to democracy;
  - The power to allocate government money was granted exclusively to the executive branch;
  - The CB was granted full independence (to become effective in 1989) and by law it was precluded from funding the government.

Economic reforms and institutional buildup in Chile: 1984-97

- The second had been introduced in 1981, slightly before the debt crisis: ***pension system reform.***
  - It consisted of moving from a bankrupt pay-as-you-go system, into a fully funded capitalization system (consisting of personal "savings" accounts managed by private specialized institutions).
- The new system has been crucial in contributing to the development of a deep domestic capital market and in improving corporate governance.

Pension System Reform



Economic reforms and institutional buildup in Chile: 1984-97

- In late 1989 a successful transition to democracy was initiated.
- The three Administrations since have maintained and strengthened the market oriented economy model, while giving more emphasis to poverty alleviation programs and policies.
- The Central Bank adopted Inflation Targeting shortly after becoming independent (in 1991), albeit with a widening exchange rate band.

Chile's Economic Performance: 1984-1997

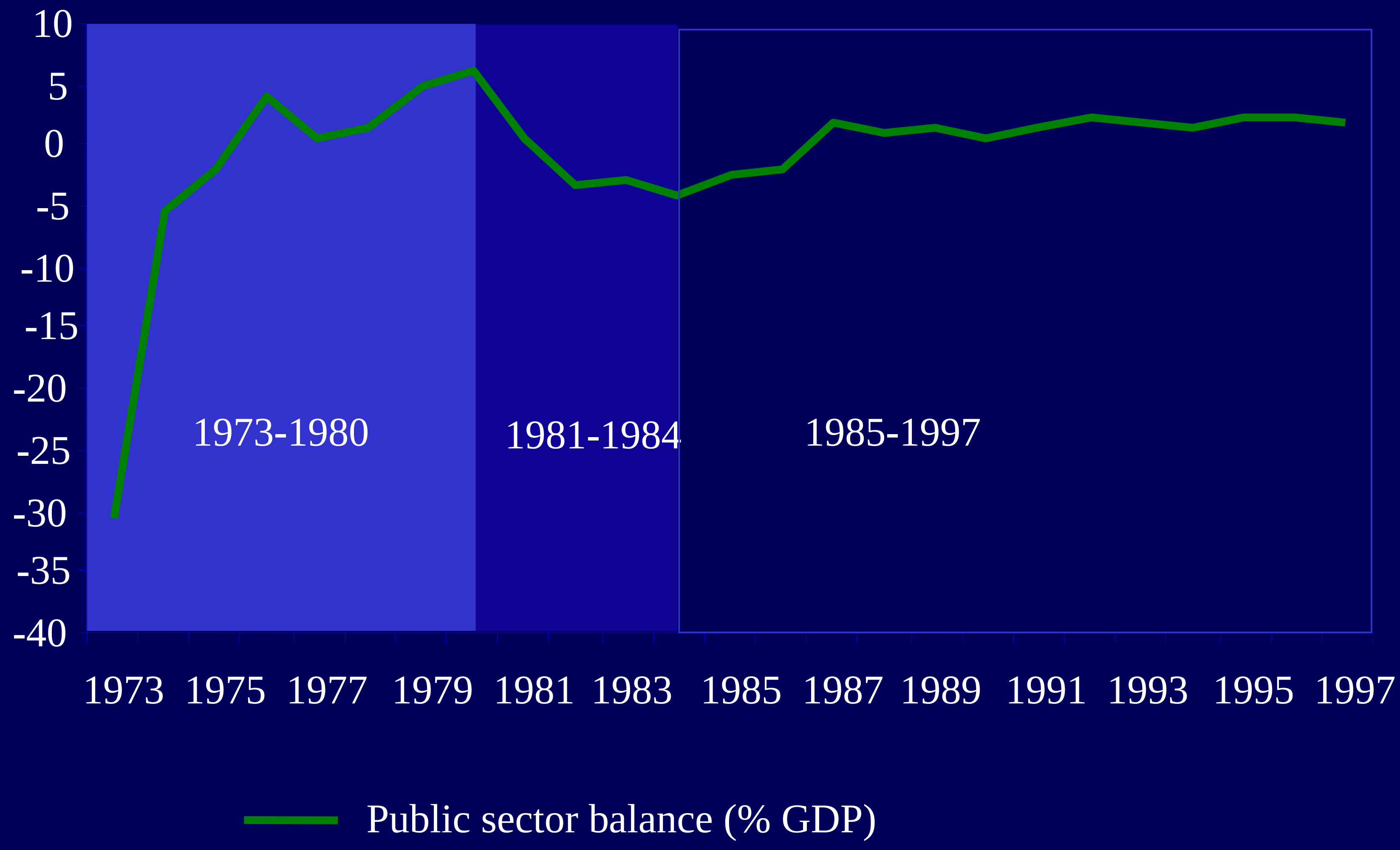
- On average annual economic growth reached 7.3%, the longest period of high growth ever.
- Inflation fell steadily into the one digit range.
- Investment in infrastructure through BOT arrangements increased significantly –as of 1998, 21 projects totaling US$ 3.6 billion had been undertaken in roads, seaports, airports, etc.

Chile's Economic Performance: 1984-1997

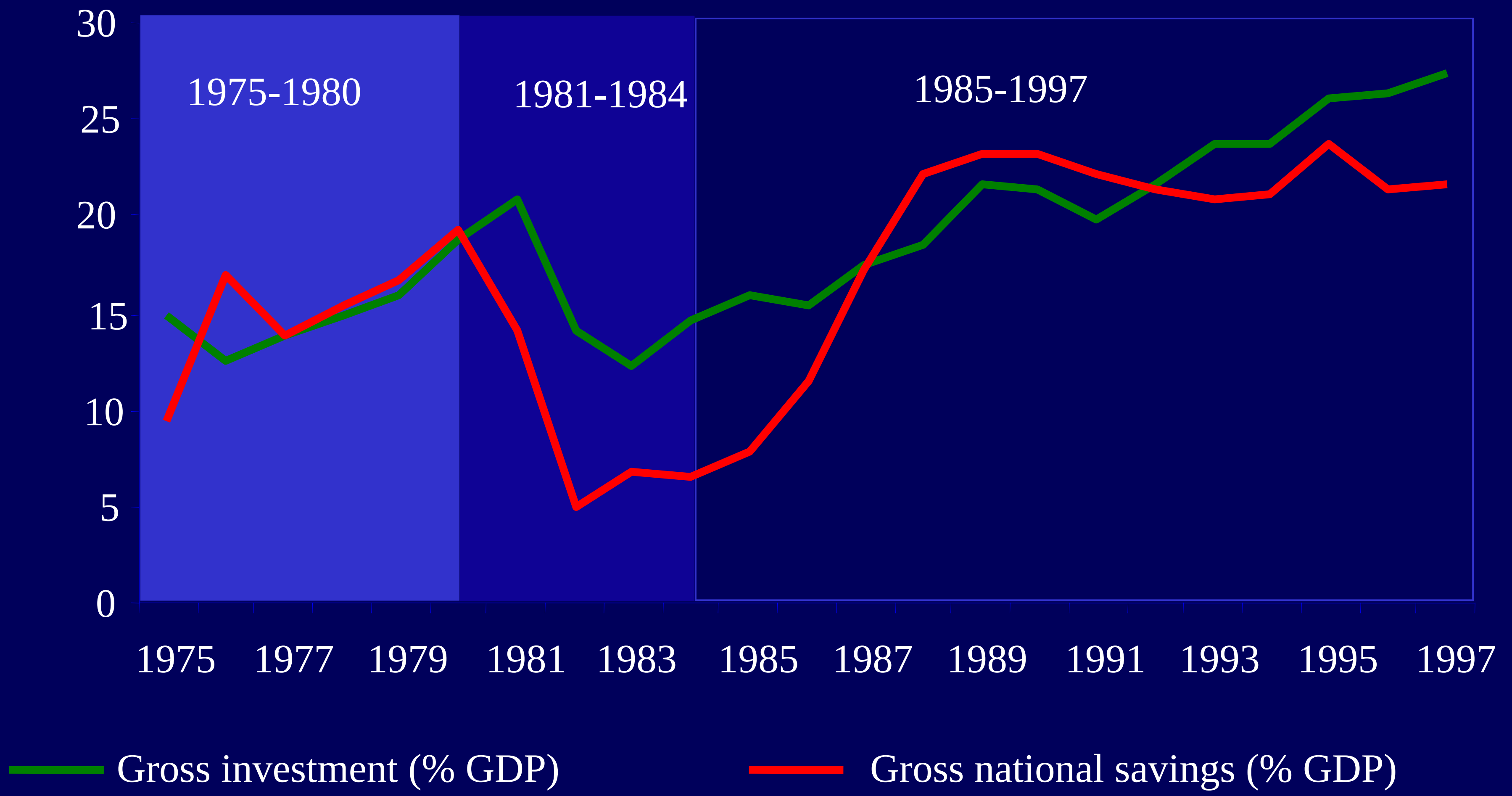
- The CB has successfully reduced inflation to the one digit range after adopting IT in 1991.

Year	Target Inflation (%)	Effective Inflation (%)
1991	15-20	18,7
1992	13-16	12,7
1993	10-12	12,2
1994	9-11	8,9
1995	9	8,2
1996	6,5	6,6
1997	5,5	6,0
1998	4,5	4,7
1999	4,3	2,3
2000	3,5	4,5
2001	2-4	2,6
2002	2-4	2,8

Chile's Economic Performance: 1984-1997



Chile's Economic Performance: 1984-1997



Economic reforms and institutional buildup in the aftermath of the Asian crisis

Several reforms are worth mentioning:

- Chile negotiated free trade agreements with the US, the EU, thus consolidating its process of integration with the world economy.
- The government established the *structural surplus fiscal rule* (2001), by which it is committed to run a surplus of 1% of GDP in steady state (the surplus is calculated with long-term values of key variables such as the price of copper and potential GDP growth)
- The exchange rate band was replaced by a floating exchange rate regime.

Economic reforms and institutional buildup in the aftermath of the Asian crisis

- The process of unilateral opening to the world economy was intensified in 1998 with a five year tariff reduction program.
- The opening up of the capital account was completed in 2001 building on a robust macro framework and a well regulated and supervised financial system.

Economic reforms and institutional buildup in the aftermath of the Asian crisis

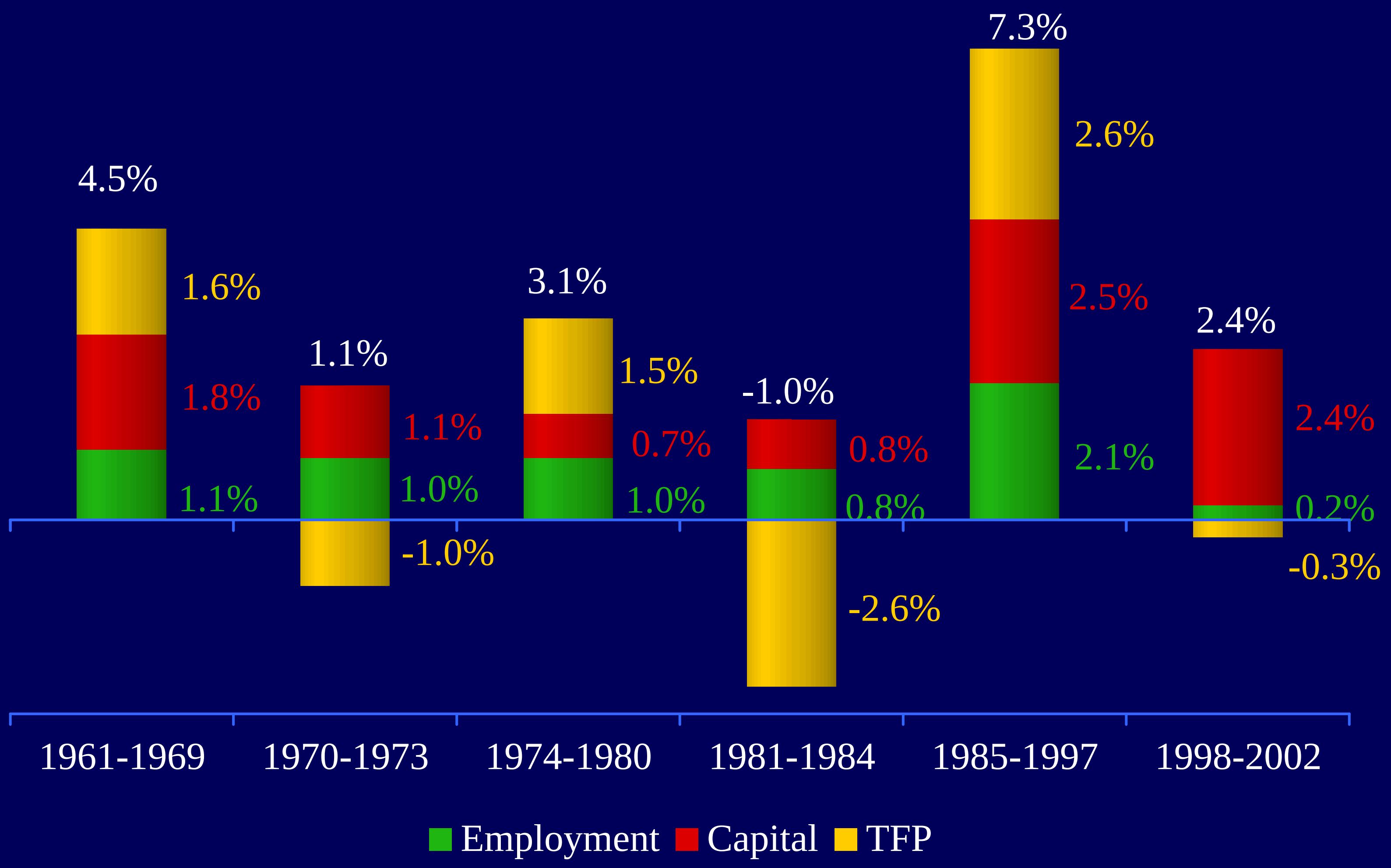
- There were other important institutional reforms:
  - campaign funding was regulated;
  - a clearer merit-based career for public sector servants was established;
- And tax and regulatory reforms occurred aimed at increasing efficiency of capital markets and providing incentives to save (i.e., voluntary tax-free contributions into personal retirement savings accounts was allowed; capital gains tax in stocks was abolished, etc.)

II. Empirical Evidence

Empirical Evidence

- Empirical studies show that jumps in the rate of growth are mainly driven by changes in total factor productivity, as opposed to factor accumulation.
- Among the main factors affecting TFP are:
  - Openness to trade
  - Financial development
  - Governance and corruption
  - Education
  - Government size and degree of bureaucracy
- After reaching macro stability, Chile focused on strengthening its institutions, which led to a period of high and sustained growth after the debt crisis.

Empirical Evidence



Empirical Evidence

- The jump in TFP growth during 1986-98, compared to previous decades, can be explained mainly by the structural reforms initiated in the second half of the 1970s and their subsequent deepening.

Empirical Evidence

- However, the series of external shocks of the post 1997 period had left their marks.
- In particular, the average rate of growth of the 1998-2002 period reached a disappointing 2.3%.
- With the policy framework of the last 25 years still in place, Chile is well positioned to start a solid recovery now that the world economy is entering a more favorable stage.

III. Conclusions

Conclusions

- The Chilean experience, as well as that of other countries, shows that policies and institutions matter.

- Beyond the first generation reforms, aimed at stabilizing the economy and opening it to foreign competition, the buildup of institutions provided the appropriate incentives for economic agents to innovate and invest.

Conclusions

- Clear and stable rules of the game are important: economic agents won't invest if the institutional setup is uncertain.
- Economic policies that create business opportunities, such as a tariff reduction, will not produce benefits unless institutions support them.