



Chile's Reforms and Performance

Conference on “NAFTA and Structural Changes: Experiences and Implications”

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* The contents of this presentation does not represent the opinions of the Central Bank of Chile. The author takes full responsibility for the presentation.



Outlook

Introduction

Initial Conditions:

Financial Repression

Macroeconomic Crisis
and Reform



Introduction

Over last 30 years, Chile has converted its closed, state-run economy into a model of free-trade, market-oriented capitalism.

For many, Chile exemplifies
the benefits of economic

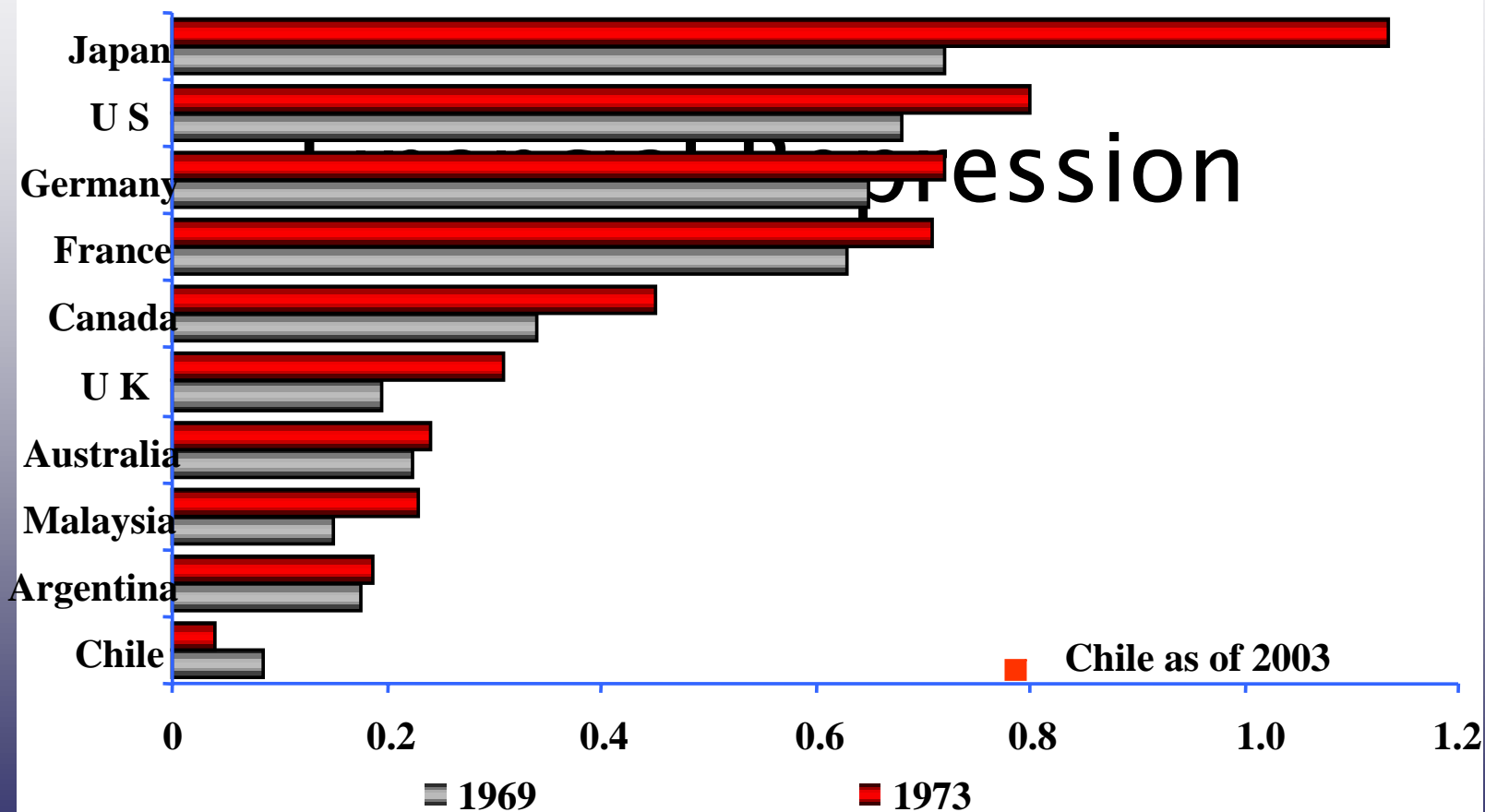


Initial Conditions

In the early 70s, the Chilean economy was closed to international trade, suffered from widespread price controls, high degree of state intervention, and severe macroeconomic imbalances.



Private credit by deposit money banks & other financial institutions, % GDP



Source: Beck, Demirguc-Kunt and Levine (2003)



II. Macroeconomic Crisis and Reform



1974–1981: financial liberalization with
weak institutions and weak macro
fundamentals.

Macroeconomic crisis and financial reforms

1981: Pension Reform

1982–1983: Economic and Banking Crisis

1984–1987: Recovery and Reordering

1987–1999: Steady Growth and Financial
Deepening

Financial Liberalization: 1974-1981



Interest rate liberalization

Abolishment of credit ceiling and mandatory lending to priority sectors

Reduction of bank's reserve requirements

Partial opening of capital account

Liberalization of the banking sector

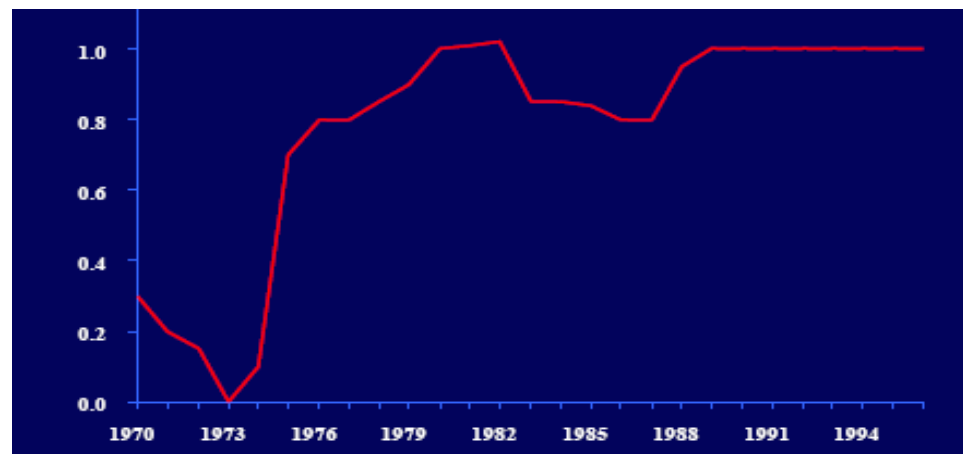
Reduction of barriers to entry

Privatization of state banks

Creation of the supervisory agency (SBIF)



Financial Liberalization Index



Gallego and Loayza 2002



An important development in this period was the pension system reform which replaced the “old and bankrupt” pay as-you-go for a fully funded capitalization system:

Pension Reform

Mandatory for new workers

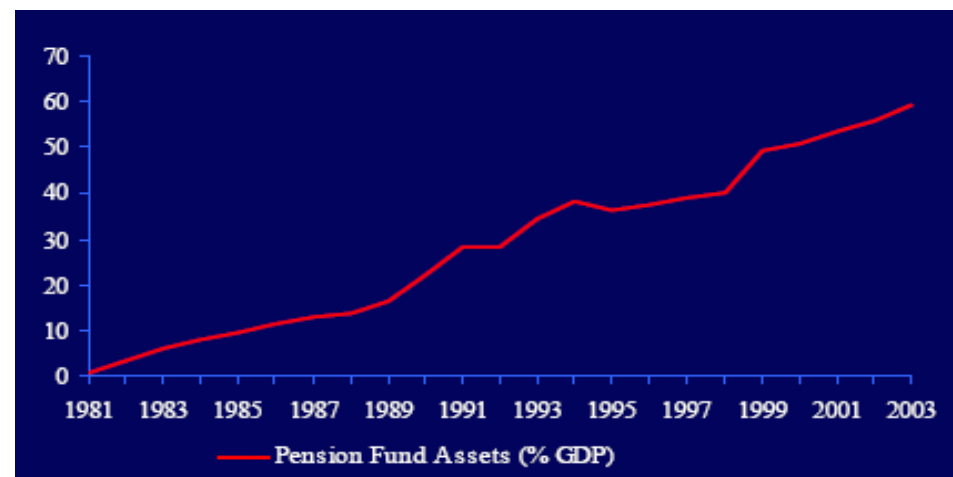
Pension funds managed by competitive private institutions

This create a new institutional investor base, contributing to improvements in corporate governance and to the emergence of long-term funding (central bank debt, mortgage securities, equity, corporate bonds).



Pension Fund Assets (% of GDP)

Pension Reform





All of the above, along with macro reforms and favorable external conditions, led to a lending boom, asset price bubbles, overheating and very rapid economic and financial sector growth.

Drastic changes in relative prices, high inflation and the lack of a well and the lack of a well-developed regulatory and supervisory framework led to banks incurring in unchecked risks and mounting systemic financial fragility (under provisioning and reporting of NPLs; connected lending; currency and maturity mismatches; overlending; etc.)



The external shock of the early 80s was all that it took to unleash a major crisis (among the costliest in the world and its full resolution took a long time).

Economic and Banking Crisis

The crisis uncovered major regulatory shortcomings and triggered a revision of several institutions and policies (second generation reforms), in particular:

A new banking law was enacted in 1986, granting more powers to regulatory entities and imposing limits on lending to banks' related parties

A new bankruptcy law, easing bankruptcy procedures, was enacted in 1983



Major reforms and measures during this
Recovering and
period comprise:

Liquidation or rehabilitation/privatization of failed financial institutions; financial institutions;
Rehabilitation of corporate and household sectors through debt rescheduling and other
programs;

New General Banking Law (1986)

A new Bankruptcy Law (1986)

The clean up and reordering process set the
Reordering
basis for a sustainable economic recovery

Average growth during 1985 Average growth during 1985-97 reached 7.3%.97 reached 7.3%



I. Where do we stand?

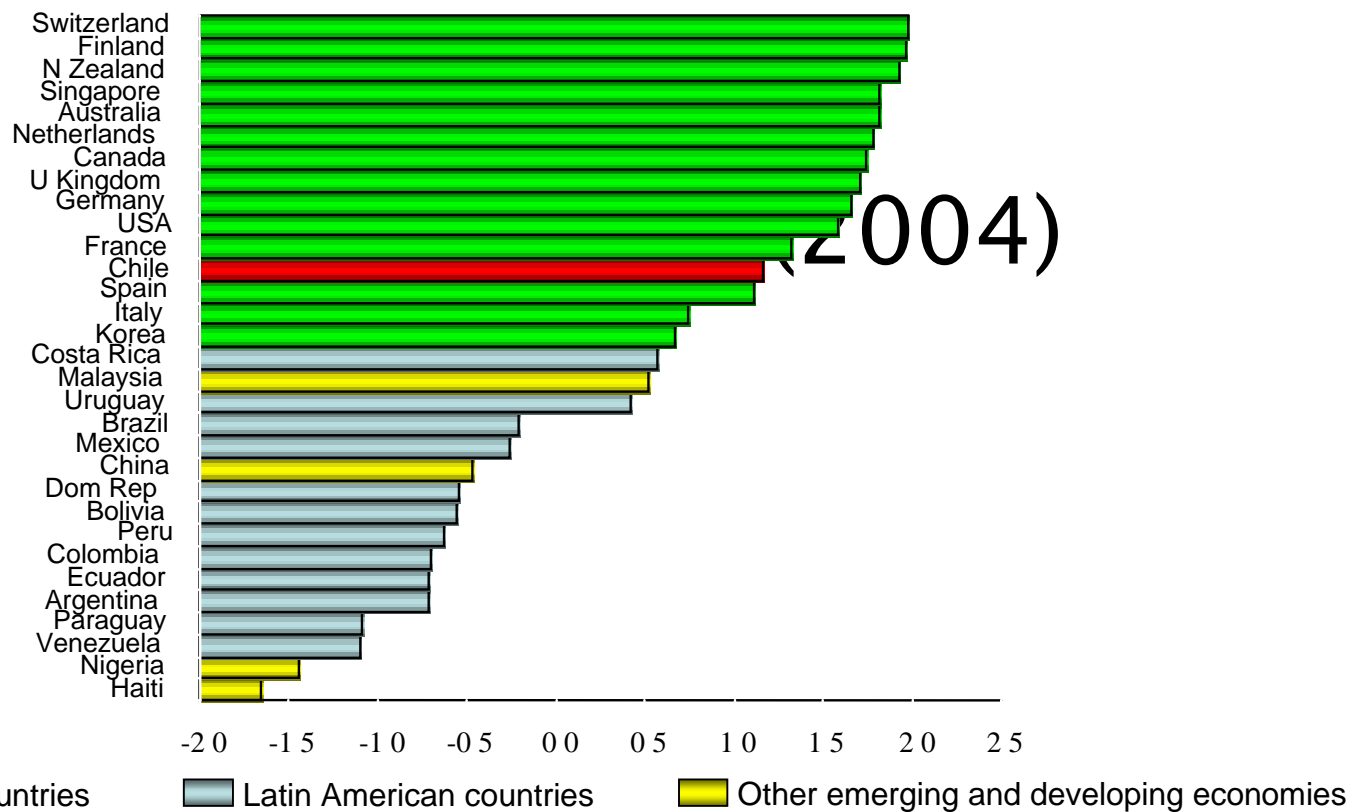


The Chilean model is based on a strong and stable institutional setting and, a competitive open market economy.

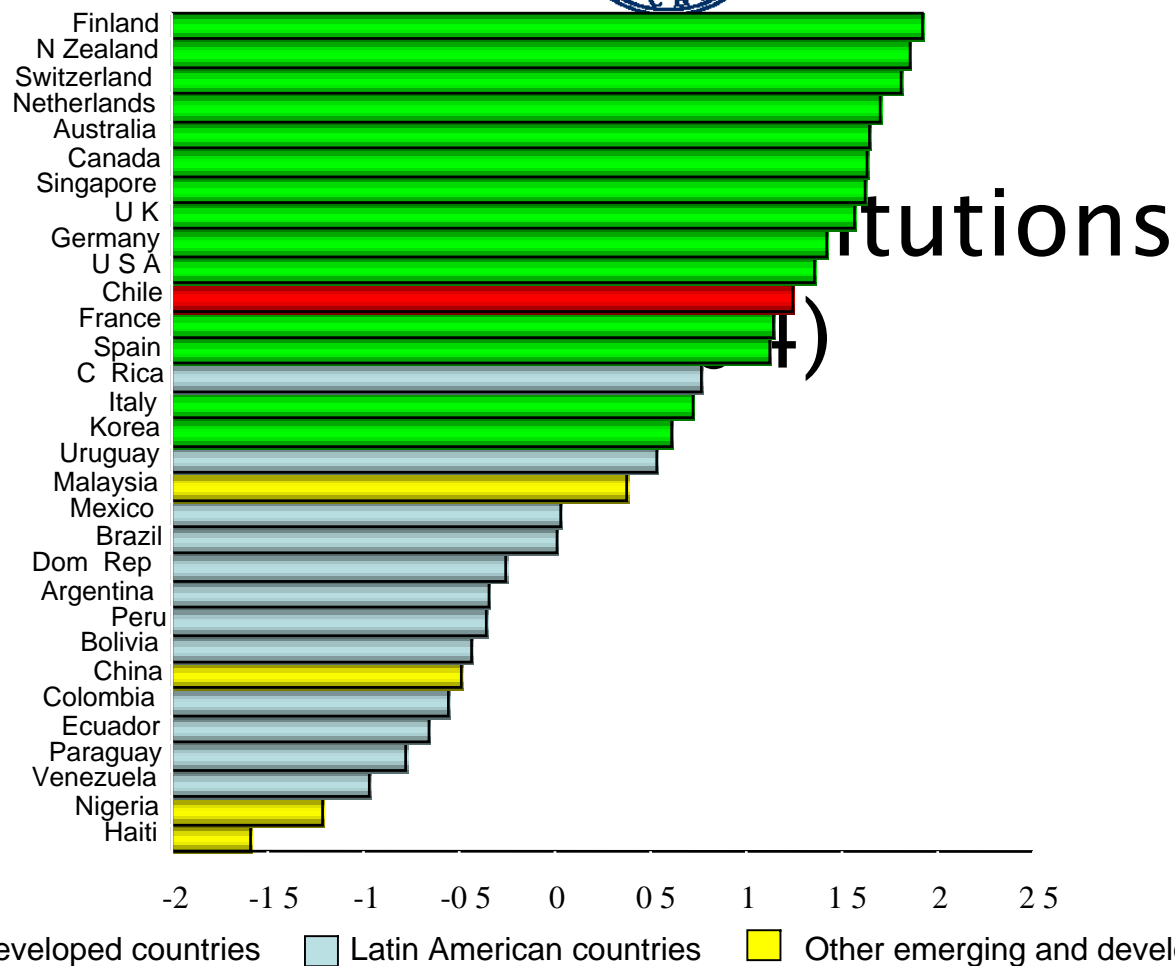
Institutional Framework

A full independent Central Bank, by virtue of a constitutional act that stipulates its mission and objectives (price and financial stability)

High competition, and a deeper integration with the world economy through unilateral tariff reductions and FTAs.



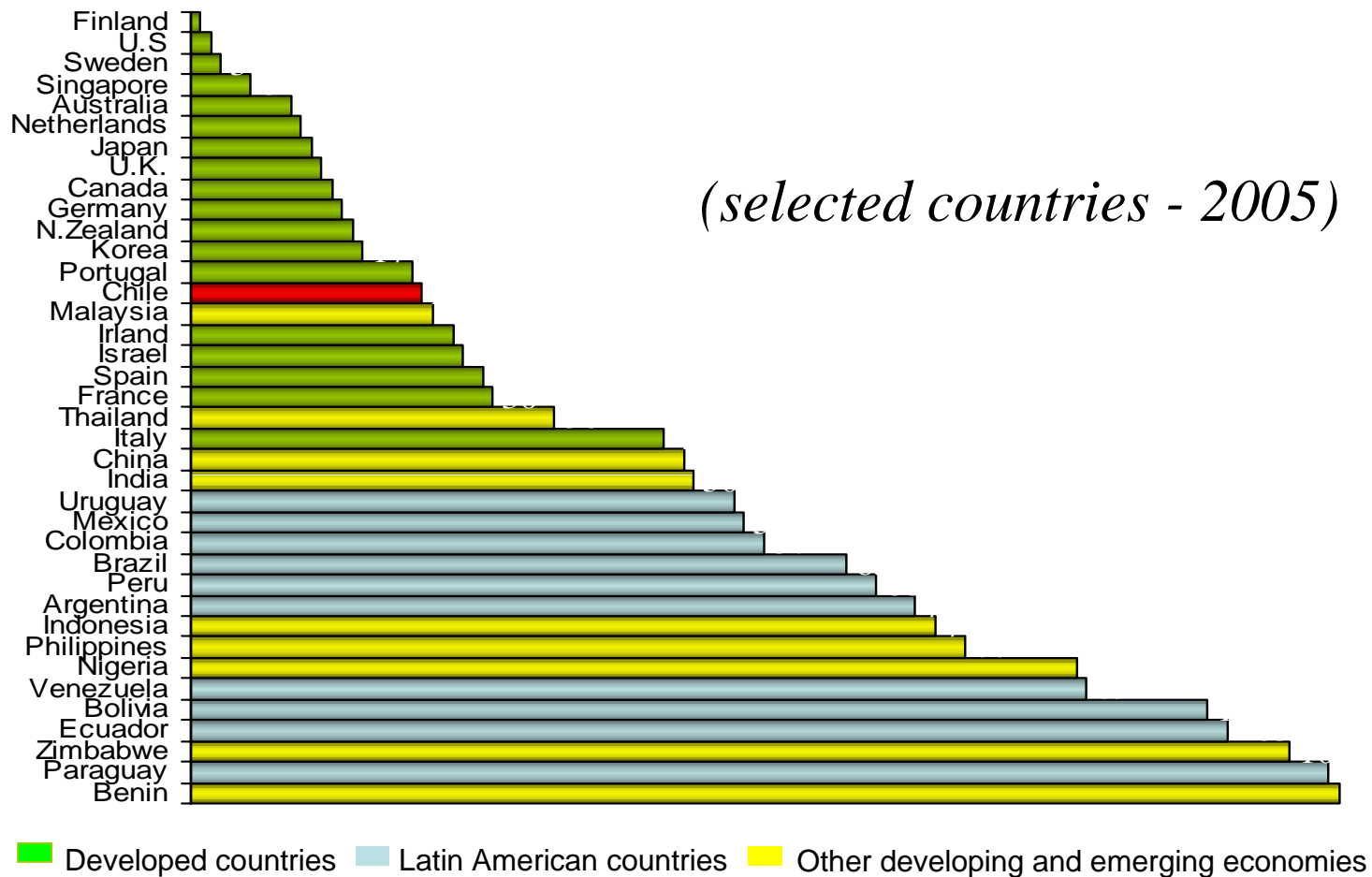
Source: World Bank (2005)



Source: World Bank (2005)

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

Competitiveness Index



Source: World Economic Forum (2005)



The outstanding records in terms of inflation and sustainable macro policies over the past 16 years has contributed to:

Institutional Framework

Macroeconomic stability

Financial strength.



The macroeconomic stability is based on:

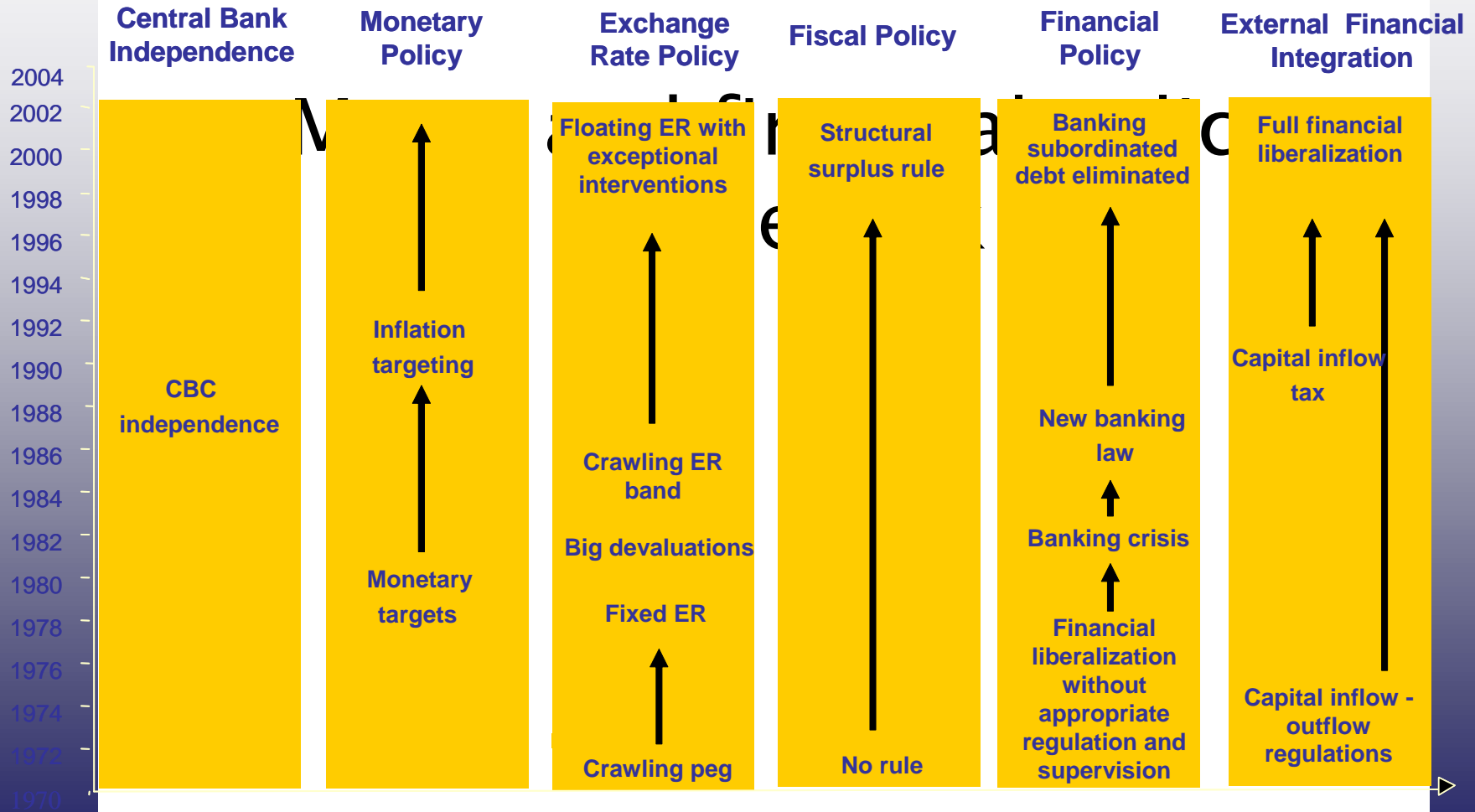
Full-fledged inflation targeting regime, complemented by a floating exchange rate.

Fiscal policy rule anchored to a 1% of GDP structural fiscal surplus.

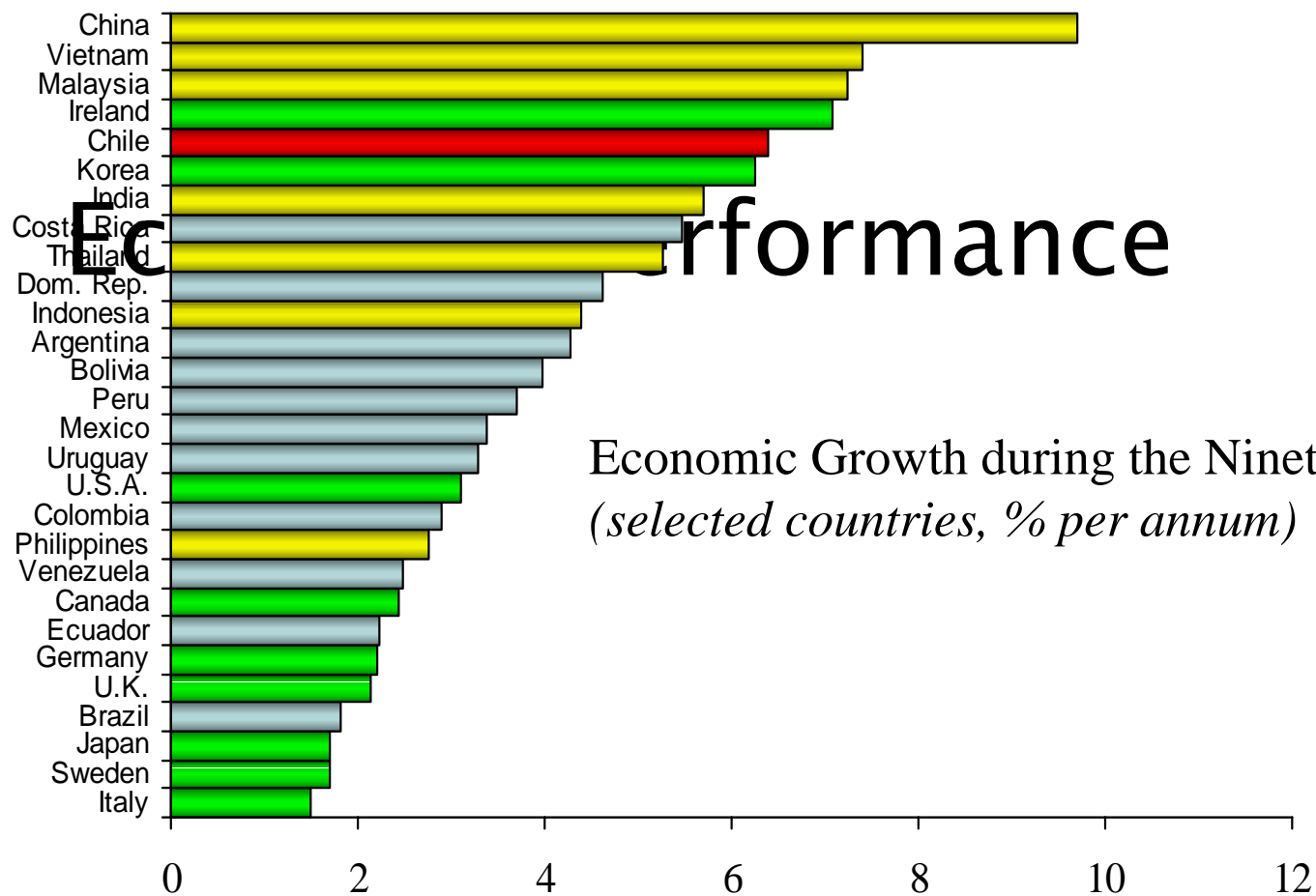
Macroeconomic Stability

Solid macro fundamentals and modern and robust institutions, all key elements for high and sustainable growth rates.

Gradual reduction in its inflation rate towards industrial countries' levels, and fiscal surpluses during most part of the last twenty years.



Fuente: Bloomberg



Economic Growth during the Nineties
(selected countries, % per annum)

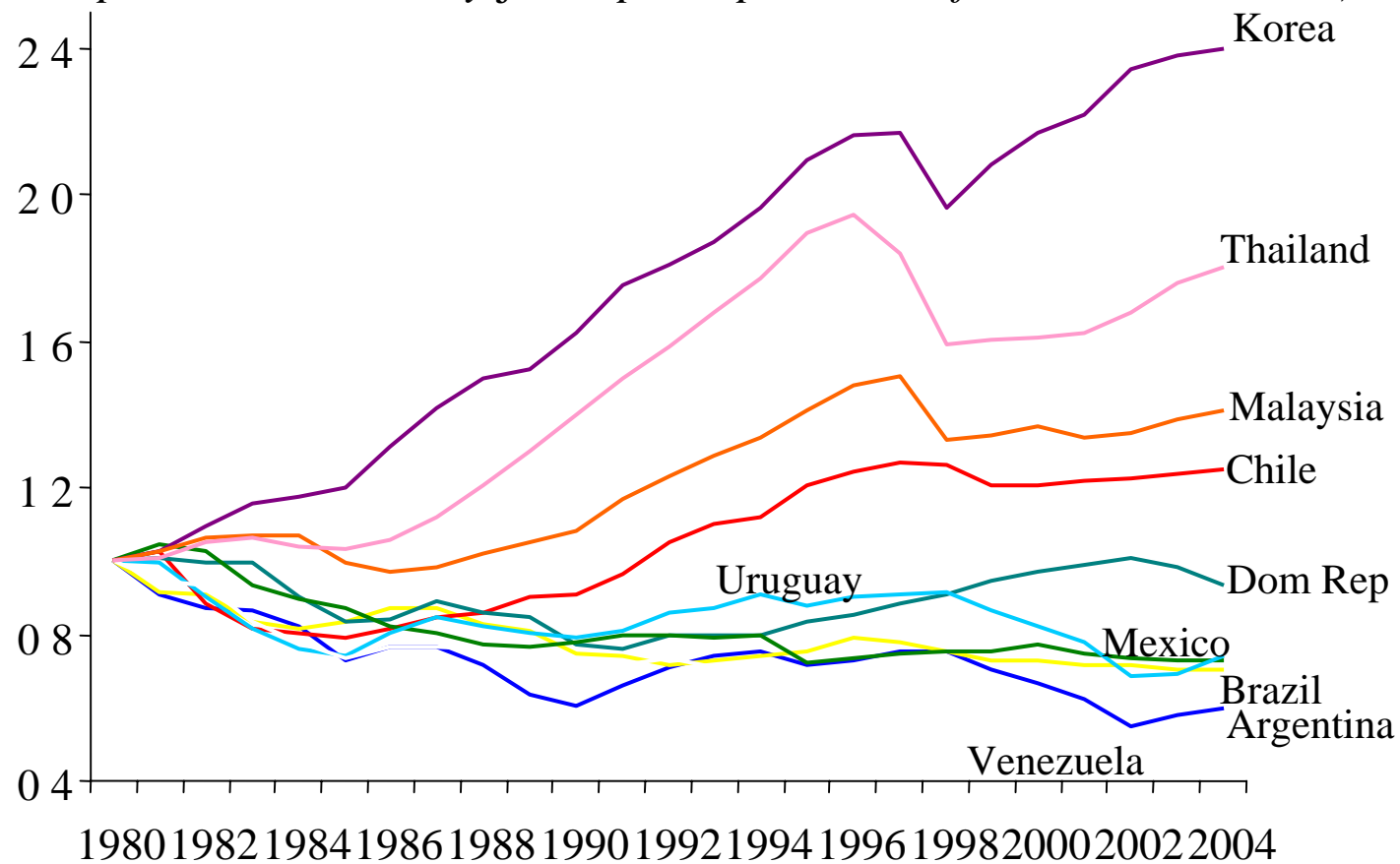
■ Developed countries ■ Latin American countries ■ Other emerging and developing economies

Economic Performance



Relative Per Capita Output

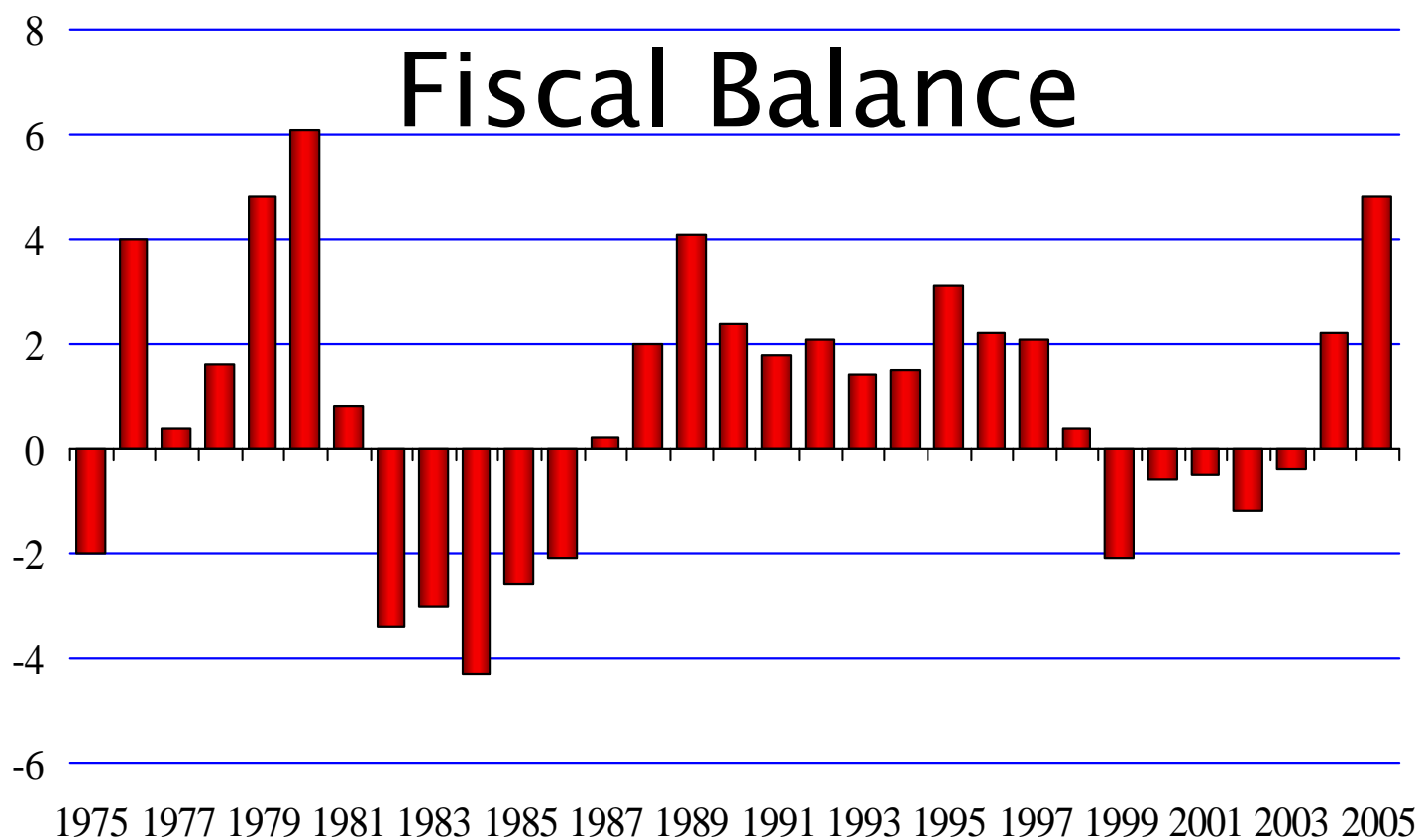
(per capita GDP in country j over per capita GDP of G-7, PPP 1980=1)



Source: Own calculations



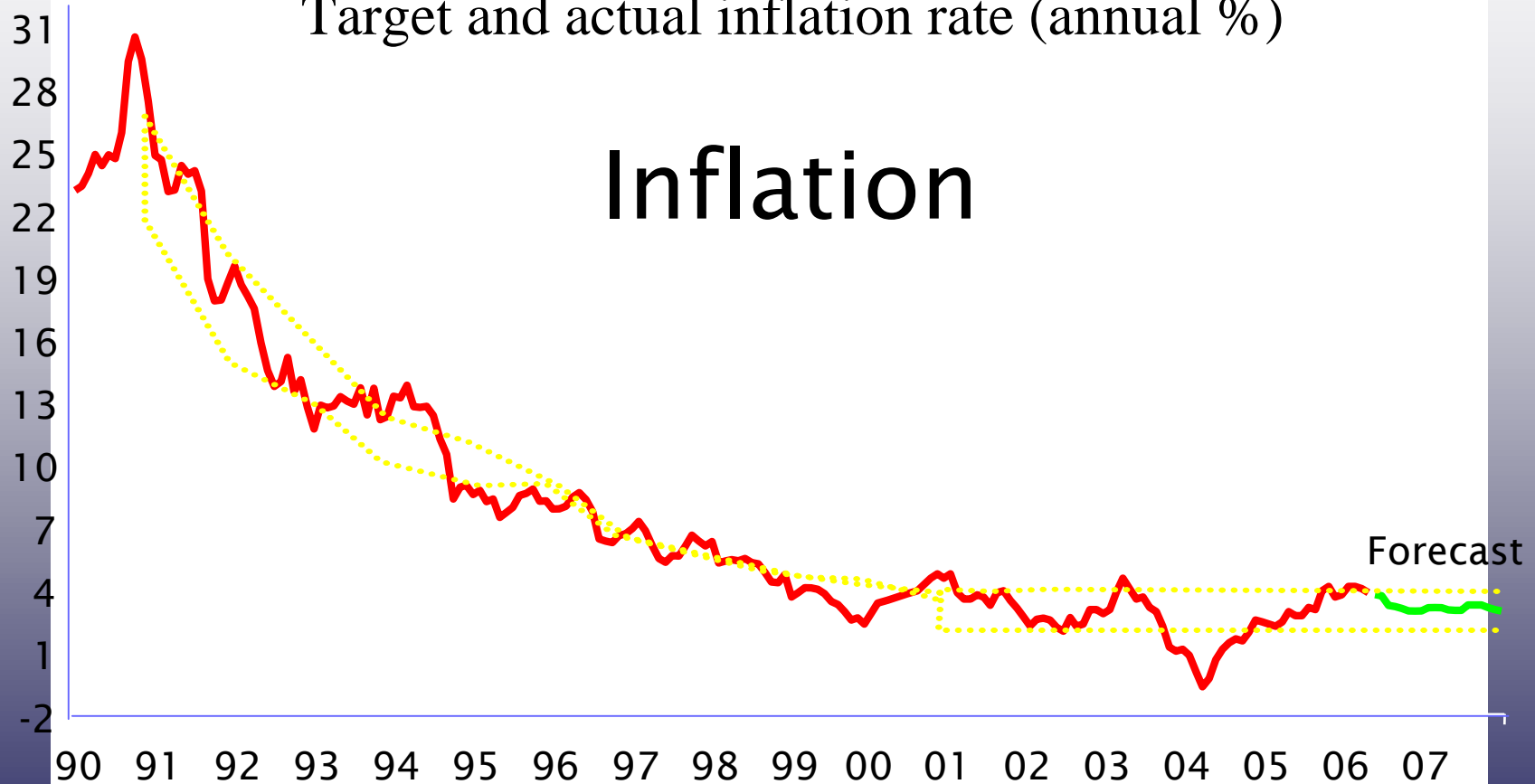
(1975-2004, Central Government, % GDP)





Target and actual inflation rate (annual %)

Inflation

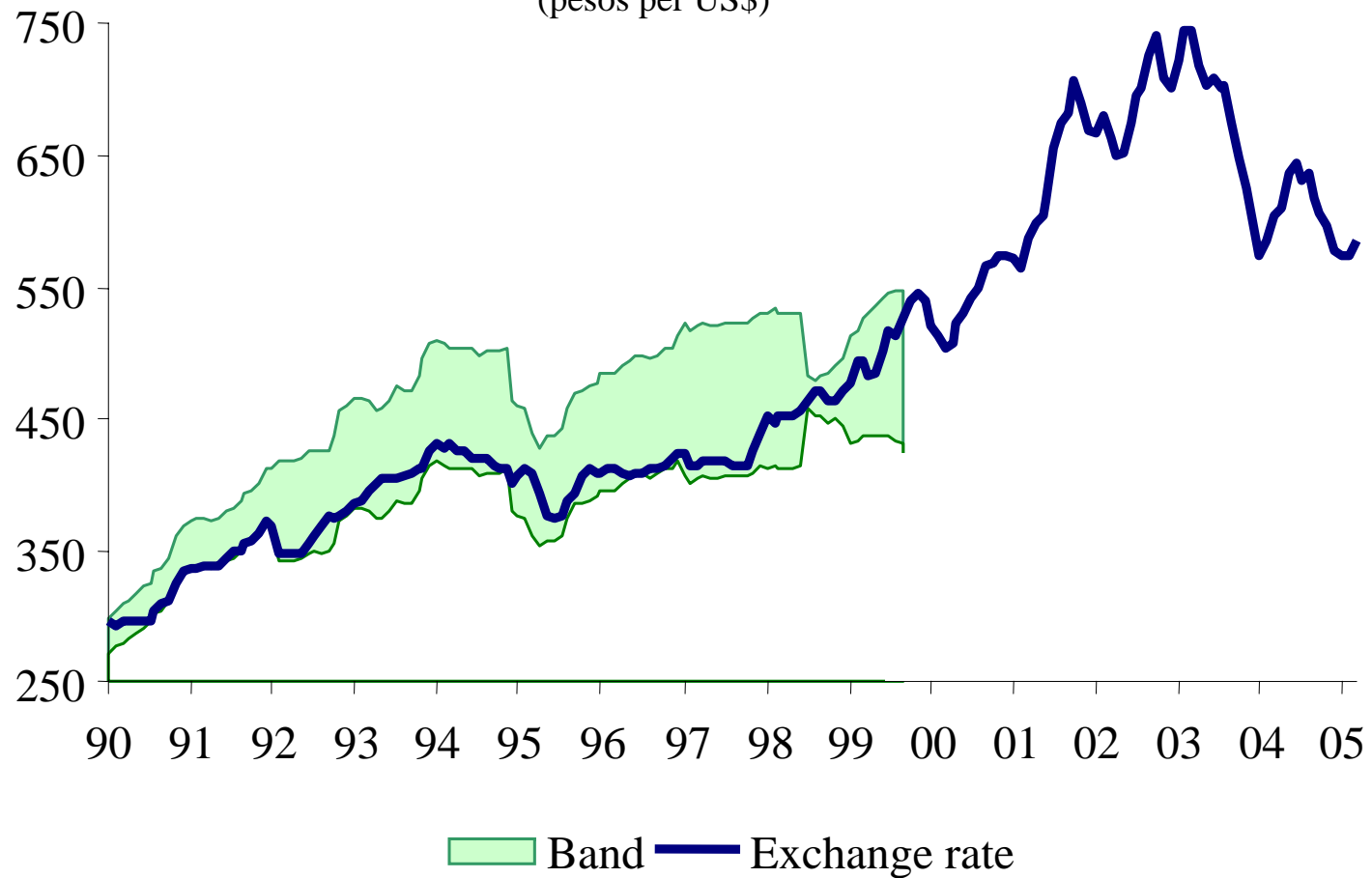


Source: Central Bank of Chile

Exchange Rate



ER (1990-2005) and ER band (1984-1999)
(pesos per US\$)

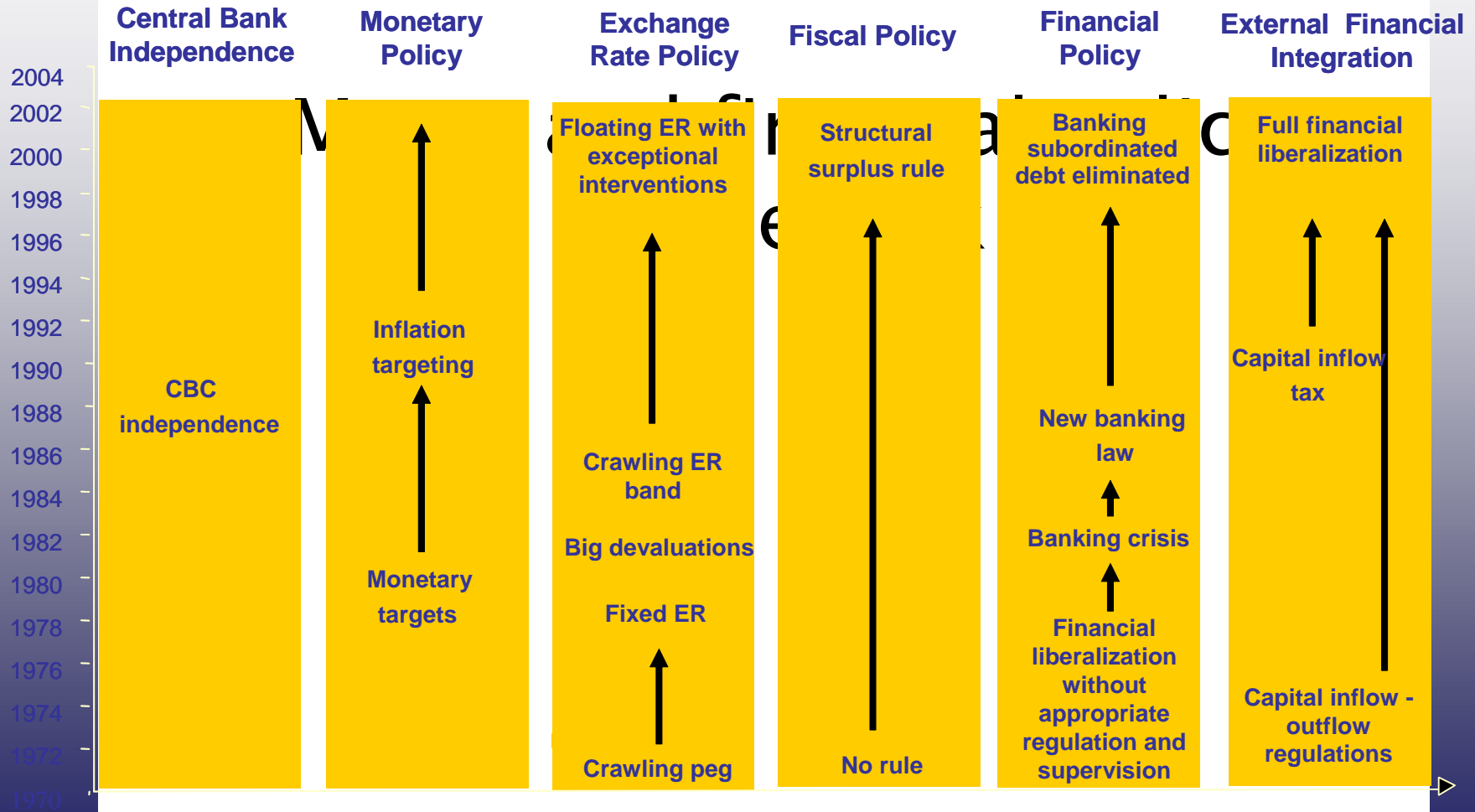




Financial Strength is based on an adequate regulation and supervision of the financial sector, in line with international standards, allowing to have a robust banking system and a well developed capital market.

Furthermore, opening of the capital account was completed in 2001, abolishing all capital controls, and new capital market reforms have been implemented recently.

This policy framework allowed Chile to become more resilient to shocks

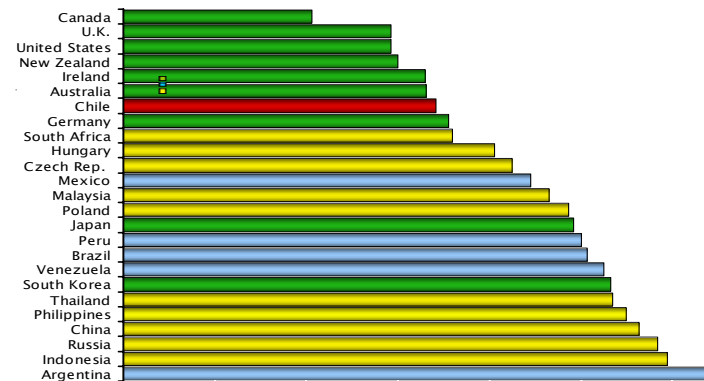


Fuente: Bloomberg

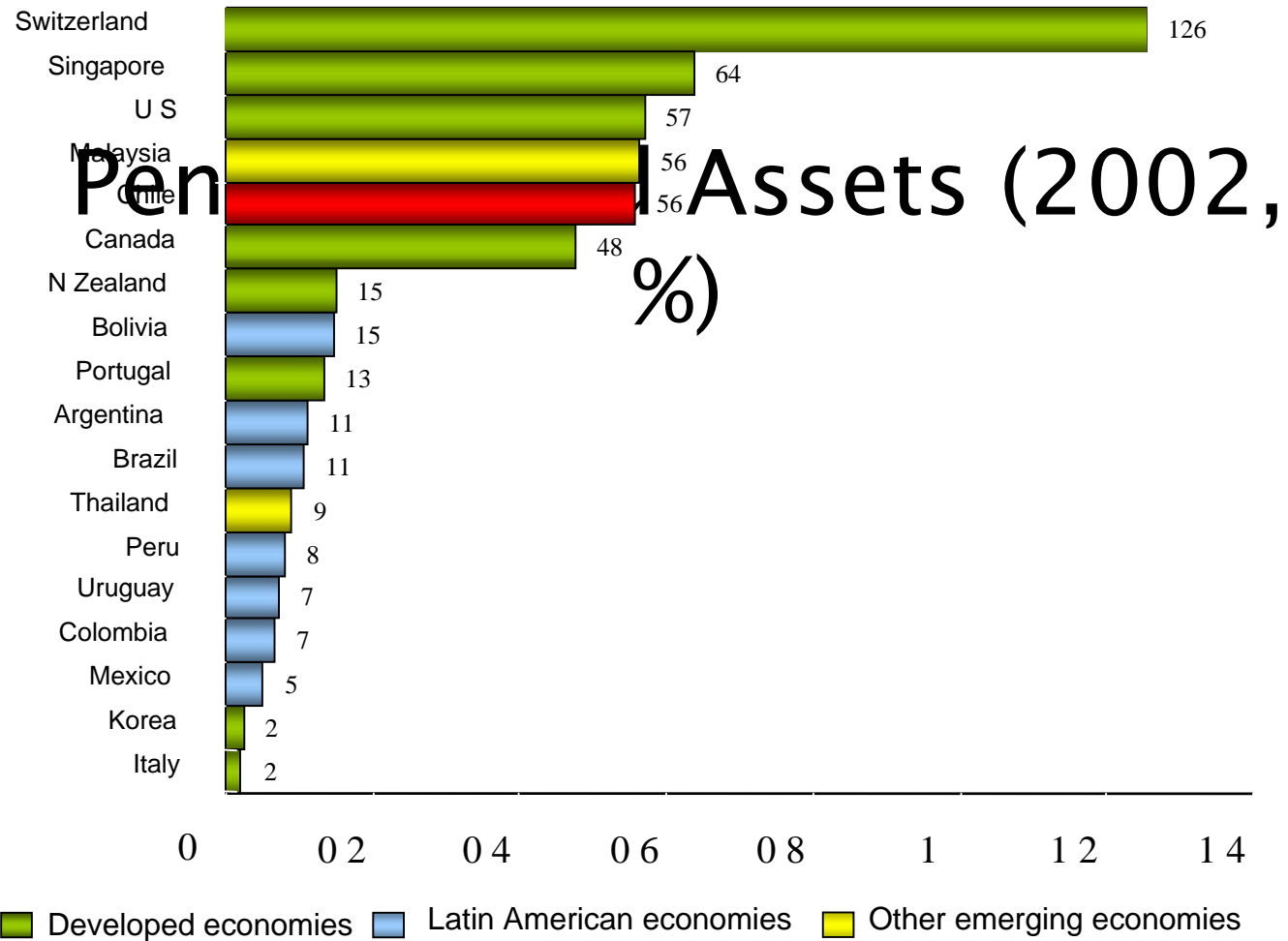


Banking Strength Index (2005)

Financial Performance



■ Developed countries ■ Latin American countries ■ Other emerging economies



Sources: OECD (2003) Davis and Hu (2005)

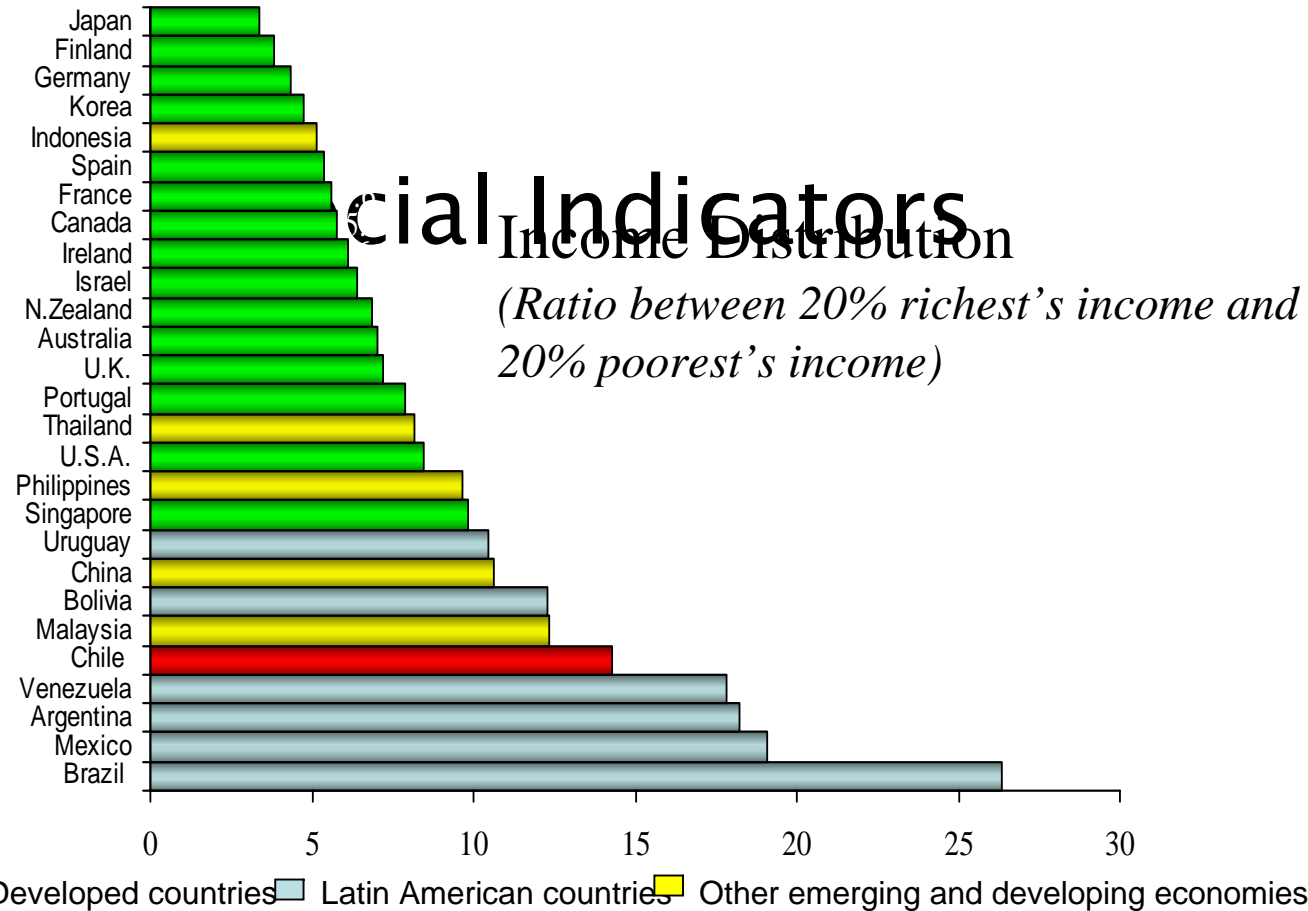
Challenges



Chile still faces some important challenges

Education quality
Technological innovation

Special attention should be given to ensure continuing stability of policies and institutions that support Chile's strengths.



Sources: WDI, World Bank (2005) In the case of Chile, the data is updated using Casen
When monetary and non monetary transferences are considered, the ratio in Chile falls to 7.6



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