*Chapter 2*

# Locking in growth: Macroeconomic and structural policy challenges

***Main recommendations***

*Thanks to its sound macroeconomic policy framework and strong institutions, Chile was well prepared to respond to the global economic recession of 2008-09 and to the natural disasters of February 2010. Consequently, economic growth rebounded quickly and indications are for continued strong growth in 2011 and 2012. The short-term focus is to rebalance fiscal and monetary policy, while the longer term challenge is to accelerate the catch-up toward higher living standards.*

- *Economic activity after the global economic crisis and the natural disasters of February 2010 has been strong. If it remains so, the central bank should continue to raise the policy interest rate to keep inflation expectations well anchored. Similarly, under the same conditions, fiscal policy could make early progress towards the objective of reducing the structural budget deficit.*
- *Chile was well prepared to face the global recession and the February natural disasters, thanks to the large financial buffers accumulated during the copper price boom. The stock of government financial assets is now reduced, and it should gradually be rebuilt to prepare for possible future contingencies. An additional fiscal rule (a floor on net government financial assets) could help to reach this goal.*
- *Convergence toward OECD living standards has slowed over the past decade. Reforms to prepare workers for the skilled jobs of the future as well as further steps to foster business activity, especially innovative start-ups, would contribute to resuming a faster pace of long-term economic growth.*

Chile was well prepared to deal with both the global recession of 2008-09 and the earthquake and tsunami of early 2010. The macroeconomic framework – a structural fiscal rule, an independent inflation-targeting central bank and a flexible exchange rate – had largely shielded the economy against overheating in the copper price boom that preceded the crisis, so monetary policy was in a good position to provide a vigorous monetary policy response to the crisis without un-anchoring inflation expectations. The government also accumulated a large buffer of financial assets during the boom, which was used for a large countercyclical fiscal stimulus. These exemplary macroeconomic policies contributed to the strong rebound of activity and helped to rapidly overcome the aftershocks of these adverse events. Going forward, the main challenge for macroeconomic policy is to return to a path of sustainable and non-inflationary growth.

Structural reforms will be needed to raise Chile's income per capita towards the average level prevailing in the OECD. Currently, Chile's per capita gross domestic product (GDP) remains only one-third the level prevailing in the upper half of OECD countries. Although there was fast convergence during the "golden age" (1986-97), growth during the past decade fell to less than half this pace. Continuing and consolidating structural reforms to enhance human capital, strengthen competition in product markets and improve the functioning of labour markets would go a long way toward resuming faster catch up with OECD living standards. Reforms to address quality and equity issues in secondary and vocational education and to foster innovation in firms would spur productivity growth and the adoption of new technologies. Productivity and investment could also be boosted by easing burdensome business regulations for start-ups, reforming the inefficient bankruptcy procedure and implementing the new Competition Law effectively, as planned by the government. In labour markets the main challenges are to raise female labour market participation from low levels and reduce informality, which remains high by OECD standards.

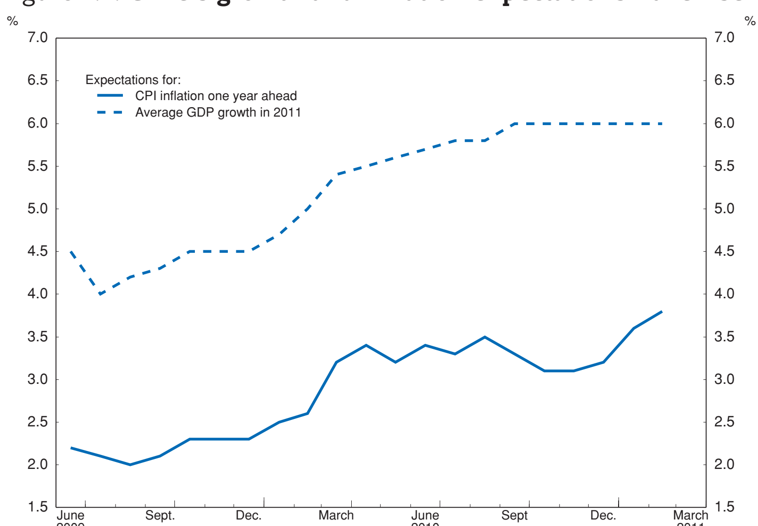
## An early rebound of economic activity and a strong outlook in the near term

After the temporary dislocation of activity caused by the earthquake during the first quarter of 2010 output rebounded quickly, with annual real GDP growth estimated at more than 5%.. Financial conditions have improved, which is reflected in increased bank lending and strong investment growth., Gross fixed capital formation in the third quarter of 2010 was almost 20% higher than one year before. As a good part of capital goods are imported, the current account surplus is turning into a deficit: the central bank expects a current account deficit of around 1.4% in 2011 (Banco Central, 2010).

The strong rebound in output is accompanied by a quick pace of job creation and gradually rising inflation. Despite the earthquake, unemployment fell to around 7% by end-2010, after having peaked at above 11% one year earlier. Headline annual inflation increased from -1.4% at the end of 2009 to around 3% at the end of 2010. This mostly reflected a fast increase of prices in the services sector, while by contrast price increases for goods were muted by the strong appreciation of the peso. Thus, a widely used measure of core inflation (excluding fresh food, administered prices and financial services) remains low (0.5% in January 2011). The central bank has raised its policy rate, but monetary policy remains nonetheless expansionary, with the short-term interest rate well below its non-expansionary (neutral) level.

While price increases remain so far contained, the inflationary effects from reduced production capacities after the earthquake and recent commodity price increases should nonetheless not be underestimated. Inflation expectations shifted up in March and have not reverted to their pre-earthquake levels (Figure 2.1). As the natural disasters disrupted supply only in the affected regions and just for a few days, the shift in inflation expectations may reflect concerns that the earthquake caused severe damages to production capacities. Moreover, the recent increases in food and energy prices on world markets and the vigorous growth in private consumption and investment are exerting upward pressure on prices. The consensus expects consumer price inflation of around 4% at the end of 2011, which is somewhat above the central bank's target of 3%.

Figure 2.1. **Chile's growth and inflation expectations have risen**




*Source*: Banco Central de Chile, Monthly Survey of Expectations.

Reconciling the twin challenges of strong growth and low inflation will be the main challenge for macroeconomic policy in the short term. According to the central bank, the earthquake of February 2010 destroyed around 3% of the country's capital stock. With the subsequent rebound in economic activity, this has reduced excess capacities and may put upward pressure on inflation. The start of major reconstruction projects in the second half of 2010 has provided a further stimulus to an already dynamic domestic demand. Recent forecasts, including by the OECD in November 2010 (OECD, 2010b), suggest that growth may exceed 6% in 2011 and 5% in 2012 (Table 2.1). Growth may come in even higher if major reconstruction projects, which have mainly been launched in the second half of 2010, exert an unexpectedly strong impulse on domestic demand. The major downward risk to the projection stems from the uncertainties surrounding the global economic recovery. As a small and very open economy, Chile is heavily exposed to developments in the world economy and a slowdown in global growth would have a significant impact on domestic economic developments.

Table 2.1. **Growth forecasts, 2011-12**

| | OECD (November 2010) | | Consensus (February 2011) | |
|---|---|---|---|---|
| | 2011 | 2012 | 2011 | 2012 |
| **Chile** | | | | |
| **Real GDP growth** | **6.2** | **5.4** | **6.1** | **5.1** |
| **Consumer price inflation[1]** | **3.0** | **3.0** | **4.0** | **3.3** |
| Brazil | | | | |
| Real GDP growth | 4.3 | 5.0 | 4.4 | 4.6 |
| Consumer price inflation[1] | 5.2 | 5.0 | 5.5 | 4.7 |
| Mexico | | | | |
| Real GDP growth | 3.5 | 4.2 | 4.3 | 4.0 |
| Consumer price inflation[1] | 3.2 | 4.0 | 3.8 | 3.7 |
| United States | | | | |
| Real GDP growth | 2.2 | 3.1 | 3.2 | 3.3 |
| Consumer price inflation[2] | 1.1 | 1.1 | 1.9 | 1.9 |
| Euro area | | | | |
| Real GDP growth | 1.7 | 2.0 | 1.6 | 1.7 |
| Consumer price inflation[2] | 1.3 | 1.2 | 2.0 | 1.8 |

1. End-of-year annual CPI inflation.

2. Average annual CPI inflation.

*Source*: OECD Economic Outlook 88 (database) and Consensus Economics (February 2011).

Barring a sudden reversal of the world economic recovery, the central bank should continue withdrawing its exceptional monetary stimulus. The partial destruction of the capital stock due to the earthquake of February 2010 has reduced excess capacities. Moreover, unemployment is falling quickly, real wages are increasing and commodity prices are rising. Private professional forecasters already expect inflation to be above the central bank's target at the end of 2011 (see Figure 2.1). If activity continues to grow at the pace expected by the consensus, the central bank should therefore continue to gradually raise the policy interest rate.

## The fiscal policy challenges ahead

Similarly, the government is right to plan a return to a more neutral fiscal stance if economic activity remains as strong as expected. Despite buoyant public spending following the natural disasters of February 2010, the government estimates that the structural budget deficit declined from 3.1% of GDP in 2009 to 2.1% of GDP in 2010, as a good part of past fiscal stimulus measures have been withdrawn. By 2014, the government plans to reduce the structural budget deficit to 1% of GDP. The government plans to achieve this objective mainly by limiting spending growth, which was exceptionally high in 2009 (18% in real terms) and around 7% in 2010, and which will partly slow down automatically as reconstruction spending tapers off.

The main challenge for fiscal policy in the near term is to finance the reconstruction after the natural disasters of February 2010 while simultaneously returning to a more neutral fiscal stance. According to the government, the reconstruction will cost around 5% of GDP over 2010-13 (USD 8.4 billion). The government will finance this mainly through a mix of tax measures, sales of government assets and debt issuance.[1] The tax measures include temporary increases in corporate and real estate taxes, a permanent increase in tobacco taxes and a modification of the mining tax. Moreover, the government plans to reduce income tax deductions for pension contributions and introduce stricter rules for the deductibility of real estate purchases. The transitory tax measures are expected to yield around 1.6% of GDP (USD 2.6 billion) over 2011-12, while the sale of government assets should bring another 2% of GDP (USD 3.2 billion). The government's financing plan further includes the issuance of debt amounting to around 1% of GDP (USD 1.5 billion). Military spending and infrastructure spending unrelated to reconstruction will be cut back. The government also plans to raise financial resources for reconstruction through improving the efficiency of the tax administration.

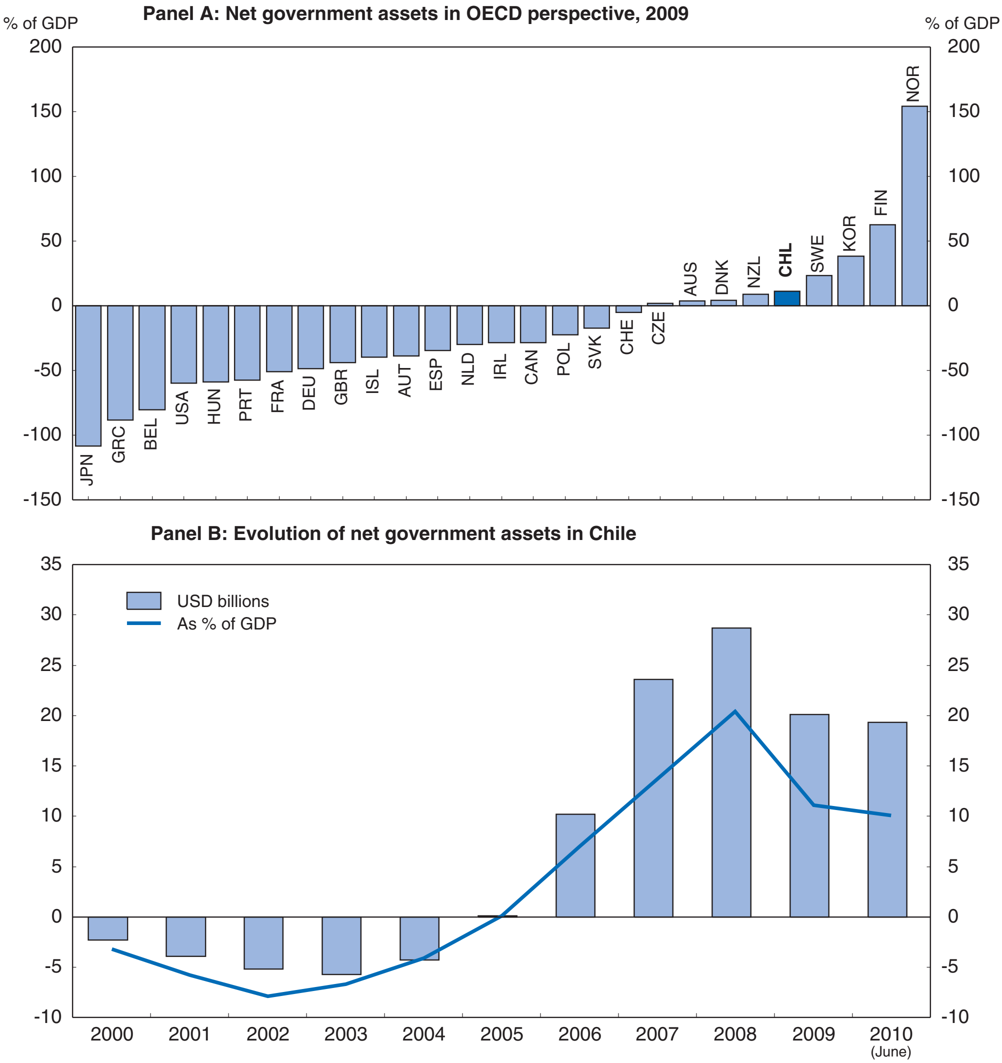
Partially financing the reconstruction through taxes and restraining spending is appropriate to facilitate the return to structural budget balance in the medium term. The structural budget deficit in 2010 was 2.1% of GDP despite the expiry of a good part of the fiscal stimulus measures of 2009. The strong economic performance since the second quarter of 2010 gives the government some room to increase taxes without endangering the recovery. The government's choice of permanent increases in some taxes is well justified on efficiency and income distribution grounds, as the tax deductions favouring pension contributions and the purchase of real estate property are very costly to the government, while benefiting mainly the wealthier parts of the population, as argued in the 2010 OECD Economic Survey of Chile (OECD, 2010a). In addition to higher taxes, it is important to restrain spending, in particular through enhanced spending efficiency, as this would strengthen the credibility of the government's fiscal policy, in particular in the eyes of bond-market participants.

The sovereign stabilisation fund was a crucial source of financing in the recent context, but the size of the fund has been sharply reduced. During the economic emergency of 2009, the government used a mix of debt issuance and repatriation of assets in the sovereign stabilisation fund to finance the fiscal stimulus. This reduced the assets in the sovereign stabilisation fund by around half, from USD 20 billion at the end of 2008 (around 12% of GDP) to USD 11 billion at the end of 2009 (Dipres, 2010). Total net government assets decreased from a peak of around 20% of GDP at the end of 2008 to around 10% in June 2010.[2]

Although from an international perspective the government remains in an enviable position to deal with economic and natural emergencies, the depletion of assets in the sovereign stabilisation fund has been relatively fast and it may be prudent to replenish it faster than currently planned by the government. This would both restore safety margins to deal with possible future economic or natural emergencies and preserve the country's low sovereign risk premiums. A comfortable financial buffer may be particularly desirable for an emerging country as Chile whose access to international capital markets may be impaired temporarily during an emergency, as during the 2008-09 global economic crisis. There should be no outflows in 2011 and 2012 if the recovery proceeds as projected. The government is therefore right to plan to finance possible headline budget deficits through issuance of debt in international and domestic markets, which Chile can currently access at relatively favourable interest rates. At the current level of assets, the sovereign fund should be reserved for situations when the government's access to capital markets is impaired and the issuance of debt would be costly.

The recent economic and natural emergencies have shown that, as a small open economy, Chile is strongly exposed to adverse global developments and, as a result of its location, to natural disaster risk. In a context of adverse events, even a large amount of accumulated assets can be depleted rapidly (Figure 2.2). If economic activity remains as strong as currently expected and downside risks do not materialise, the government would be in a good position to consider a faster rebalancing of the budget and an early replenishment of the sovereign stabilisation fund than currently envisaged. This would also reduce upward pressure on the Chilean peso, which has appreciated strongly over the past months.

Figure 2.2. **Chile's net government assets are positive, but have declined**[1]




1. End of period, central government for Chile, general government for other countries.

*Source*: OECD, Economic Outlook 88 database; DIPRES 2010.

There are many ways to achieve a fiscal adjustment. Policies that would be least harmful for growth and jobs would be to enhance the efficiency of government spending, further limit inefficient tax expenditures and raise the property tax rate. The 2007 *OECD Economic Survey of Chile* (OECD, 2007) made several recommendations to enhance spending efficiency in health care, education and housing. On taxation, shifting the tax structure toward consumption and property taxes and away from corporate and personal income taxes is the least harmful approach (Johansson *et al.*, 2008). The reason is that consumption and property taxes are less harmful to work and investment incentives. In this sense, Chile's tax structure is currently relatively growth-friendly as it relies more strongly than other OECD countries on value-added tax (VAT) (OECD, 2010a, Figure 2.10). The last *OECD Economic Survey of Chile* (OECD, 2010a) made several recommendations to broaden tax bases by eliminating distortionary and inequitable tax exemptions, such as abolishing or limiting remaining VAT exemptions; closing tax loopholes associated with corporations created for the sole purpose of deferring the payment of personal income taxes (*Sociedades de Inversión*); and increasing the property tax rate.

## Refining the fiscal rule to further enhance resilience

The strength of Chile's fiscal framework notwithstanding, the government could consider complementing the fiscal rule by a floor on assets accumulated in the sovereign stabilisation fund to ensure the accumulation of a sufficient fiscal safety buffer in good times. Introducing a rule on the minimum amount of assets accumulated in the sovereign stabilisation fund would help to guide the budget towards a position that permits the accumulation of financial assets during good times. It would also help to maintain the credibility of the structural fiscal rule even when the government temporarily deviates from it. At the beginning for 2009, for instance, the government first announced a reduction in the fiscal structural target from a surplus of 0.5% of GDP to balance, so as to be able to conduct its fiscal stimulus programme. Ex-post the government appears to have run a structural deficit of 3.1% of GDP in 2009. Modifying the structural balance target or deviating from it temporarily may be justified in a situation of severe economic stress, as during the 2009 global economic crisis. Complementing the structural fiscal rule by a floor on assets accumulated in the sovereign stabilisation fund would guide fiscal policy towards the replenishment of the sovereign fund in the wake of such deviations. To allow for some flexibility, the floor on accumulated assets would have to be accompanied by a clearly-defined escape clause, for instance if the output gap crosses a threshold or a natural disaster hits.

Alternatively, the government could consider complementing the structural balance rule by a floor on *net* government assets (a ceiling on *net* government debt). A floor on *gross* assets accumulated in the sovereign stabilisation fund would have some drawbacks: the target could, for instance, be reached by issuing debt and transferring the proceeds to the stabilisation fund.

Automatic corrections of past deviations from the structural balance target, as in the German and Swiss fiscal rules, would also support the accumulation of a sufficient fiscal safety buffer in good times. In Switzerland and Germany ex-post deviations from the structural balance rule are reported in a notional account. As soon as the amount accumulated in the account exceeds a pre-specified threshold, the government has to take corrective action. In the Swiss case, corrective action is triggered when the negative balance in the notional account exceeds 6% of expenditure (around 0.6% of GDP). The government then has three years to bring the balance in the notional account below this threshold. In Germany, corrective action is triggered when the negative balance in the notional account exceeds 1% of GDP. The maximum annual correction in the structural deficit is capped at 0.35% of GDP and the adjustment has to take place only in periods of economic recovery. In Germany, deviations in the structural balance due to errors in the forecast for the output gap are not stored in the notional accounts whereas they are fully accounted for in the Swiss case.

The government could enhance the counter-cyclicality of the fiscal rule by explicitly acknowledging the possibility of temporary deviations from the structural balance target in emergency situations. As the 2009 global economic crisis and the 2010 earthquake have shown, the government may have to respond to emergency situations through discretionary fiscal policy actions. In these situations, merely allowing the automatic stabilisers to play out may not be sufficient. The possibility of temporary deviations from the structural balance target should therefore be acknowledged and be clearly linked to observable events, such as output contractions or natural disasters. This would further enhance the credibility of the fiscal rule by limiting ad-hoc modifications of the target while giving the government more flexibility to respond to shocks through discretionary fiscal policy. Escape clauses from the fiscal rule should come with clearly-specified rules on the return to the original target. Complementing escape clauses with a floor on assets in the sovereign stabilisation fund or a ceiling on net government debt would ensure temporary deviations do not become permanent and fiscal policy remains on a sustainable path.

Complementing the adjustment of revenues for the influence of the business cycle by a correction of expenditures would also strengthen the fiscal rule's counter-cyclicality. Across OECD countries, expenditure tends to increase in economic downturns, mainly due to benefit payments. Allowing a cyclical increase of spending during downturns would give the government more leeway although in Chile the effect would likely be small, given the comparatively small size of benefit payments. However, spending is likely to react more strongly to the cycle in the future, as Chile has expanded its unemployment insurance system. Chile could also consider adjusting the structural balance for short-term changes in the exchange rate, which are particularly important for the peso value of copper revenues.

## Structural reforms to accelerate the convergence toward higher living standards

Apart from strengthening the economy's resilience to adverse events, the government should also consider structural reforms to enhance long-term growth, in particular in the areas of secondary and vocational education and in innovation policy. Although educational attainment has improved markedly over the past decades, the quality of secondary and vocational education remains uneven. Moreover, the access to quality secondary education is among the most unequal in the OECD, which prevents a large share of the population from reaching its full potential. Recent reforms to strengthen quality assurance and to ease access to quality schools for children from weak socio-economic backgrounds will raise the long-term growth potential and should be continued. In vocational training, experience from other OECD countries, such as Germany and Korea, shows that supporting work-place training and effective consultation between training institutions and employers can give a boost to quality. Innovation policy may also have a useful role to play to enhance long-term growth by raising productivity. Until recently, the government focused on support for basic research in public institutions. To promote innovation and technology adoption in firms, efforts to strengthen links between research institutions and firms and to promote technology diffusion should be continued.

Continuing structural reforms in product and labour markets would enhance productivity and investment, and create more and better jobs. In product markets, the main challenges are to continue reforms to reduce regulatory red tape for start-ups, to reform the burdensome bankruptcy procedure, and to effectively implement the 2009 competition law reform. In labour markets, female labour market participation, which is among the lowest in the OECD, needs to be enhanced. Informal employment, which remains high by OECD standards, could be reduced by improving employers' incentives to hire in the formal labour market. As argued in the 2010 *OECD Economic Survey of Chile* (OECD, 2010a), this could be achieved by developing a Chilean model of "flexicurity", which would combine reduced severance pay with an expanded unemployment insurance system.

## Conclusion and summary

Chile's economy has proved highly resilient to the adverse events of the past two years. In the short term, the main challenge for macroeconomic policy will be to ensure the recovery in economic activity is sustained, and dynamic domestic demand does not result in renewed inflationary pressures. The government also faces the challenging task of re-building fiscal safety buffers in a highly uncertain global economic environment without endangering the ongoing recovery. Resuming the pace of growth of the late 1980s and 1990s will require structural reforms, including in education, product and labour markets. The OECD, with its long-standing cross-country experience in these areas, is a useful forum for discussion with other governments. Its regular structural policy analysis in the Economic Surveys of Chile (OECD, 2003, 2005, 2007, 2010) and for all OECD countries and the BRIICS (Brazil, Russia, India, Indonesia and China) in *Going for Growth* (see OECD, 2010c for the latest issue) may provide the new government with valuable inputs to address remaining policy challenges and achieve its ambitious agenda.

### Notes

1. The tax, debt, and asset sales mix is part of the broader financing strategy of the government, which will cover the initial fiscal deficit, reconstruction spending and the cost of the government's programme. GDP shares are expressed in terms of the level of GDP in 2009.

2. Beside the sovereign stabilisation fund, total gross government assets include the pension reserve fund, the petroleum stabilisation fund, the infrastructure fund and other government assets. As gross government debt is low (around 6% of GDP in 2009), total net government assets (gross asset – gross debt) are larger than the gross assets in the copper stabilisation fund.

## Further reading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