CHILE

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2002: UNFULFILLED EXPECTATIONS

Forecasts of GDP growth rate for 2002 kept tumbling from the end of 2001 from a range of 3.5–4.5 per cent to 2.1 per cent at end-December—faring worse than the two previous years. Neither active monetary policy nor exports made their expected contribution to growth.

The reduction of the Central Bank interest rate by 350 basis points during 2002, and 25 additional basis points in the first days of January 2003, seems only to have fed money demand. Consumption remained stagnant while investment fell even in absolute terms.

Exports were lower in nominal dollars than in 2000 and 2001 despite improving in real terms by 1.3 per cent. In particular, copper prices fell from 82.3c/lb in 2000 to 70.7c/lb in 2002, while the prices of other exports followed the same path.

The Agenda for Growth—a product of negotiations between the private and public sectors—includes a wide range of measures to be taken to reverse recent negative trends and recover high growth rates. In short, it covers fields such as

- the regulatory framework (telecommunications, power, fishing) and competitiveness
- technological policy (modernisation of information technology)
- tax composition (reduction in direct taxes, increase of indirect taxes)
- capital market (modernisation and simplification of financial markets)
- public sector efficiency (mainly in health, education, and poverty support delivery and of judiciary services)
- the labour market (greater flexibility in length of contracts, training, improvements in protection of unemployed)
- and export expansion.

Efforts to fulfil the Agenda were not sufficient to reverse negative trends. Fulfilment of the Agenda depends on executive decisions and legislative action and, consequently, requires political support which may not be easily obtained because of the shaky situation of the '*Concertación*', the coalition of four political parties which support the president.

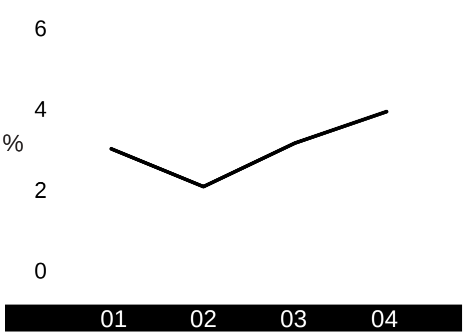
Despite the large monetary expansion during 2002, inflation remained within the Central Bank's 2–4 per cent fixed inflation target range at 2.5 per cent. Significant increases in money demand and a large pool of unemployed resources restrained price rises.

2003 AND 2004: OUTLOOK

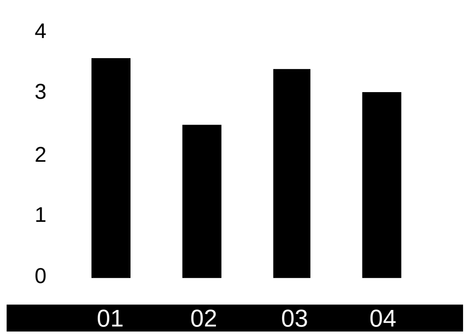
Several positive signs suggest a reversal of previous trends, already evident in 2003, to develop in 2004, allowing GDP growth to reach 3.2 per cent and 4.0 per cent in 2003 and 2004 respectively.

Employment is higher and rising, and unemployment is lower. There has been a consumption-driven improvement in economic activity, spurred by the very low interest rate, greater credit availability and more optimistic prospects. However, uncertainty surrounding taxes as well as other aspects of the Agenda for Growth and about the external environment, plus

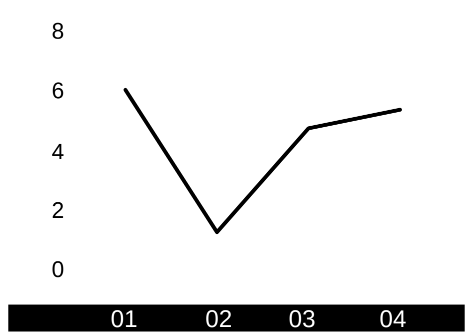
GDP growth



CPI inflation



Export growth



domestic quarrels among members of the President’s team, are restraining the surge of domestic demand. Consumers are slow to react to the modest good news available, while the outlook remains opaque for investors who prefer to postpone their decisions. The low rate of investment will hamper growth in the near future and could hinder a return to the high growth rates of the 1990s.

Exports are anticipated to increase and export prices are expected to improve, stimulated by the signing of a wide agreement of integration with the European Union, Korea and the European Free Trade Association (EFTA). The final agreement reached with the United States will be signed on a long-expected free trade agreement (negotiations have been in progress since 1990, but neither party has yet signed). To the extent that it is realised, the Agenda for Growth will reinforce these positive trends, albeit with some lags.

The copper price is also expected to increase slightly given the successful growth of China and Korea, two important markets for Chilean copper production, alongside the decision by BHP Billiton, the main private producer in Chile, to cut production by 390,000 metric tons and the purchase by CODELCO of 200,000 tons for inventories.

Inflation will remain in the range of 2–4 per cent over the period (following a consistent downward trend since 1990) despite a significant increase in M1 during 2002. Mild cost pressures and a relatively stagnant production gap will keep inflationary pressures under control since it is unlikely that M1 growth will continue at the same high rates. However, oil price rises could create some upward pressures on prices. The Central Bank will then have to keep an eye on this trend owing to the high significance of oil prices within the CPI—where the oil price represents 12 per cent of the total basket. A CPI rise of 0.8 per cent in February 2003 (strongly influenced by both oil price and exchange rate increases) implies inflation of 3.8 per cent over the last 12 months—close to the ceiling of the Central Bank’s target inflation range. This is a sign that the long-term trend of declining inflation has been reversed.

Capital inflows and outflows will increase slowly despite volatility in regional capital markets. Brazil is a source of concern given its high external debt and Lula’s economic policy so far, while the situation in Venezuela is adding turbulence of its own. The hope for improvement in capital inflows lies in the strength of ties created through Trade Agreements reached during 2002. A related positive sign is the latest sovereign bond issue (January 2003) in the New York market with a spread of 163 basis points and a potential demand of 4 times the value of the bond. Since investors seem to be willing to discriminate among Latin American countries, Chile could expect to improve its recent performance and, by 2004, reach an absorption of inflows in the order of 5 per cent of GDP.

Both unemployment and participation rates are falling. Given prior developments, an expected low growth rate of activity and modest pressures for higher real wages, it is likely that unemployment will keep falling, while employment rises, albeit slowly, during the period 2003–04.

Volatility of financial markets in the last two quarters of 2002, transmitted from the region through the exchange market, has been quickly internalised by the Chilean financial market. The Central Bank intervened when the exchange rate in the free market passed C$760 to the US dollar. The current actual value of C$730 is still too high given the fundamentals.

Monetary policy will become less expansionary given the expected recovery of internal demand and the need to restrain inflation.

Despite the volatility surrounding the Chilean economy and the lower than expected level of activity, the Chilean financial sector remains healthy and is expected to keep its flexibility and solvency during the 2003–04 period.

RISKS FOR THE BASIC SCENARIO

Disturbances in Venezuela, a higher risk of terrorism and Brazil’s foreign debt problems could reduce expected capital inflows and terms of trade and erase some of the anticipated gains in GDP growth and the current account. However, it is hoped that the treaties agreed in 2002 with the European Union, United States, European Free Trade Arrangement and Korea will foster more trade, lead to better terms of trade, attract more foreign investment and capital inflows could balance the negative impacts—but only after 2004. In addition, by enhancing world trade conditions, the entry of China and Chinese Taipei into the WTO, the progress of the Doha Round, the liberalisation of China could all improve the basic scenario presented above.

The next round of trade treaty signatures (with Japan, Singapore, New Zealand and India) is already effectively decided, but will not have much impact on trade during the period 2003–04, other than possible confusion and increased administrative costs in Chile, and the chance of a Guiness Book of Records entry for treaty signings.

The path to growth

Chile’s GDP growth rate averaged 6.4 per cent between 1995 and 1998, but only 2 per cent since 1998. Hopes for a growth revival hinge on the Agenda for Growth and on the impact of free trade agreements.