

CHILE

2003: REVIVAL

Growth during 2003 was expected to be 3–4% late in 2002 and will probably end up at 3.2%. Annual growth recovered slowly but surely from its 2.1% rate in 2002, with expansive monetary and fiscal policies probably playing a role in preventing a lower growth rate and the recovery is being driven by expanded foreign demand for commodities and the gradual reappearance of international financial flows. The most dynamic sector has been mining, which was growing at an annual rate of 8% by the third quarter of 2003.

The reappearance of international financial flows into the country is reflected in increased asset prices and expanded lending by the banking sector. The stockmarket increased slightly over 50% during 2003 in nominal terms, peaking in October at an annual growth rate of 66%.

The year ended with some turmoil for non-traditional and less profitable export sectors due to the appreciation of the peso. The global depreciation of the dollar combined with the renewed interest of foreign capital in investing in Chile has driven the currency up very strongly. The mobile year ending on 16 February 2004 saw the strongest nominal appreciation of the Chilean peso of its history: 29.93%. Moreover, the Multilateral Real Exchange Rate index calculated by the Central Bank indicates that competitiveness is back at the level it had in 1995 at the peak of Chile's last export and growth cycle. The

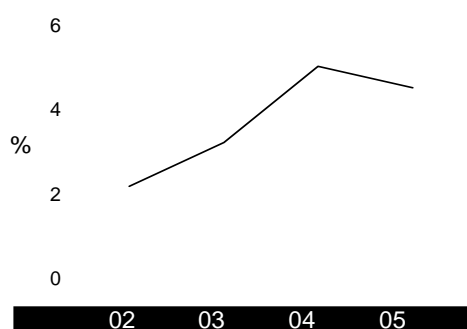
discomfort of exporters is not completely unjustified, however, since this same index shows a multi-lateral real appreciation in the mobile year ending in January 14%. What makes the exporters uncomfortable is the speed of the change rather than the level of the exchange rate.

Although investment has been slow to reflect the renewed access to international financial flows, there has been an increase in job creation. The seasonally adjusted unemployment rate was 8.1%, the lowest in five years. It seems safe to expect firms to use up any spare capacity during the first months of 2004 and to start to invest aggressively. Consumers have had a cautious attitude towards the economic recovery and have not accelerated their spending. This is not strange since job creation only started to grow significantly towards the end of 2003.

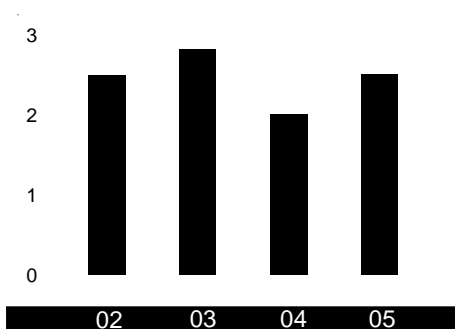
Inflation seems to be under control. The Central Bank has significantly undershot its target range of 2–4%. Annualised inflation started 2003 3.01% and is now -0.01%. If the recovery continues, we should probably expect the Central Bank to increase interest rates preemptively at some point in the second half of 2004 or early 2005.

The three most significant policy events of 2003 were the signature of a FTA with the United States, the Honesty-Integrity Law (public sector), and the implementation and parliamentary approval of the laws of the Growth Agenda Agreement.

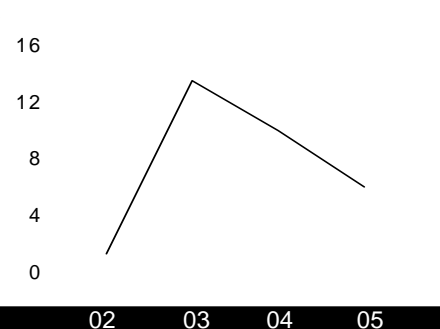
GDP growth



CPI inflation



Export growth



OSCAR M.
LANDERRETICHE
Universidad de Chile

The FTA with the United States and the comprehensive free trade and economic cooperation agreement with the European Union is the culmination of a successful and sustained strategy of bilateral and reciprocal trade liberalisation implemented by Chile since the 1990s that has complemented the unilateralist approach of the 1980s. This trend continues, as the FTA with Korea is processed. The result is that Chile has secured a position as one of the most commercially open economies in the world.

The first half of 2003 marked a clear low point for the current administration, which struggled to manage an explosion of corruption scandals, which shook the poll numbers of the government coalition and compelled the government to restructure.

The silver lining of the scandals has been the reaction of the political system. The new governor of the Central Bank is one of the most reputed and credible economists in the country, with an impeccable academic and consulting career. Politically he is considered to be close to the opposition to the government. Also, there has been a major revision of the government's anti-corruption checks as well as the rules and procedures surrounding financial instruments issued by public agencies.

During 2003, the government and opposition advanced in the implementation of the Growth Agenda Agreement. This was the result of a joint commission between business leaders and the government that tried to work out a set of reforms oriented towards reaccelerating the growth rate. Politically, the Agenda also compensated the business elite for a labour reform implemented in the early stages of the government of Ricardo Lagos in 2000 and 2001. The Agenda is a collection of new laws, administrative dispositions and criteria that would facilitate the creation of new businesses. Its main features include a substantial lowering of taxes on research and innovation, the creation of tax tribunals and the

implementation of a mechanism for attracting venture capital to fund smaller and more innovative projects. However, its most important feature is an Administrative Silence criterion, by which an entrepreneur may assume that his applications have been approved if the regulatory agency does not explicitly deny permits or licensing within a reasonably short time.

2004 AND 2005: SLOW BUT SURE

As usual, the Chilean economy will continue to follow closely the fluctuations of the world economy. The acceleration in demand for copper and the depletion of world stocks seem to guarantee a relatively high copper price in the near future. Capital flows will probably increase steadily during the year and should react enthusiastically to the FTAs and the capital market reforms associated with the Growth Agenda.

Less traditional export sectors will resume growth after the glitch caused by the strong appreciation of the currency during late 2003. The unwillingness of the Central Bank to intervene the exchange rate during this event has probably gained them some credibility in the eyes of the market, since it is only the fourth year of a fully flexible exchange rate regime. It is possible this episode will boost the development of the exchange rate insurance market that has been slowly developing.

A consensual growth forecast for 2004 would be 4.5%, however I forecast a higher growth rate of 5% due to a strong international demand for copper, a recovery in internal demand as soon as consumers adapt to the improved employment situation and the continuation of expansionist policies in the United States in the lead-up to the presidential election. A consensual forecast for 2005 would be 5%, however I expect a sharp fiscal and monetary contraction in the United States, leading to a deceleration of growth in Japan, China and the European Union. We should also expect a monetary tightening in Chile

early in 2005. Growth in 2005 will be, in my opinion, closer to 4%.

Inflation should accelerate during the year and end within the Central Bank's target range, although closer to the lower bound of 2%. The market expects the inflation rate to converge to the centre of the target range (3%) in 2005, however, the Central Bank of Chile has shown strong asymmetry in its willingness to deviate from the target. I forecast that in 2006 it will remain close to the floor of the range at 2%, even if this means higher interest rates. The Central Bank will also find it politically convenient to have a tough monetary stance in 2005 since it will be a presidential election year and hence an opportunity to assert its independence.

Exports will grow strongly during 2004 and not so much in 2005 if the United States economy breaks as expected. There are no consensus market forecasts on this, but, given the current strong growth of the mining industry, it is reasonable to expect a 10% growth rate for exports in 2004, falling back to 6% in 2005.

UNCERTAINTIES

The main uncertainties for the Chilean economy come from the fiscal and monetary stance that the United States will adopt in 2005. If the US economy continues to give mixed signals, especially on jobs (which is unlikely), there is some probability that the next administration will delay the adjustment. If the adjustment is delayed, then of course the export and growth prospects of the Chilean economy will change, though expected inflation should remain the same.

Another question is the economic autonomy of China, Korea and Japan. Much has been said about the dependence of these economies on United States' demand. However it is conceivable that the region is moving into a phase where foreign investment makes a permanent bet on their future performance and finances a strong and persistent performance that is more independent of United States' fluctuations.