Kick-Starting Chile's Growth Engine

By Luc Eyraud, Lusine Lusinyan, and Marika Santoro

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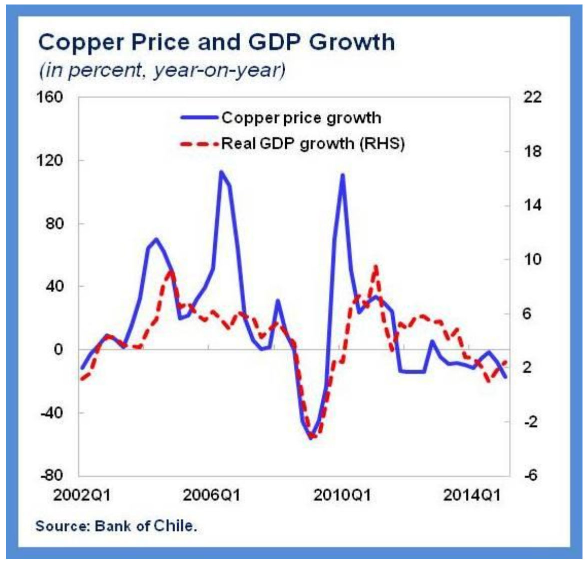
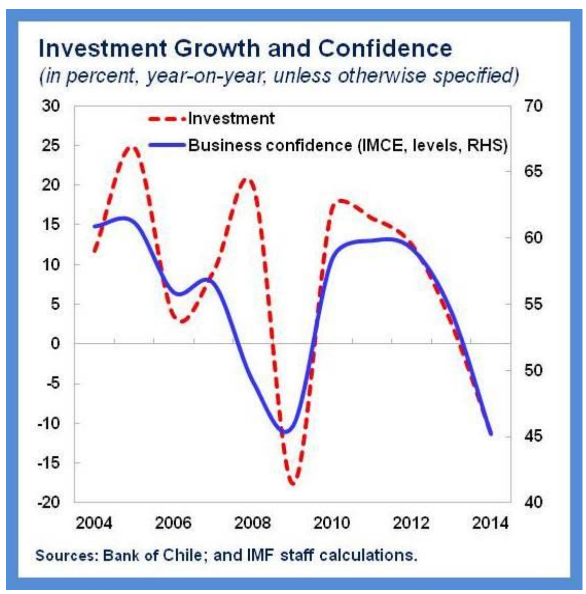
Like many countries in Latin America, Chile is facing difficult times. After a decade of high growth driven by very favorable external conditions, Chile's growth has dropped to 1.9 percent in 2014 from 5 percent, on average, between 2004 and 2013, mainly reflecting a sharp fall in private investment.

Is this downturn just a temporary lull in Chile's recent high growth path, or is it the beginning of a "new normal" for Chile's economy? In our recent report on Chile, we show that the slowdown reflects Chile's adjustment to the decline in commodity prices since 2011, but also the uncertainty and adjustment costs from the structural reform agenda announced in 2014 to foster a stronger, more sustainable and inclusive economic growth over the long run.



The end of the commodity boom

To a large extent, the slowdown in growth is the result of what appears to be the end of the commodity "supercycle." After the mining boom in the second half of the 2000s, copper prices have decreased by about 40 percent between their peak in early 2011 and July of this year when they reached their lowest level in 6 years. Given the importance of the copper sector in the Chilean economy (it represents 10 percent of Chile's GDP, originates half of exports, and receives half of foreign direct investment inflows), a large economic effect was inevitable. Our analysis shows that a persistent decline in copper prices has a large and long lasting impact on the level of GDP in Chile, which may take up to a decade to recover. For instance, a 20 percent decline in copper prices from their average high level in 2006–14 may subtract about 3 percentage points from Chile's GDP growth over the next 5 to 10 years.



Transitory costs of structural reforms

However, copper prices do not tell the whole story. The decline in investment in 2014 was brought on by a sharp fall in business confidence that cannot be fully explained by the decline in copper prices and economic activity. This may in fact reflect the reaction of Chile's business community to the uncertainty associated with the ambitious structural reform agenda announced by the new administration early last year.

This agenda rightly aims at fostering stronger and more inclusive growth, and addresses well-known gaps in Chile's education system and infrastructure. If well implemented, the reforms have the potential to boost productivity and growth in the medium-term, but they may entail costs in the short-term. One of them is associated with the higher cost of capital from the tax reform that was approved last September to help finance spending in those areas. But a spike in uncertainty is also the inevitable byproduct of a few reforms that promise to introduce significant changes in Chile's economic environment, including the reform of the labor market that is currently under discussion in Congress and the announced constitutional reform.

Boosting Chile's growth

To reignite growth, Chile has to work on both fronts—adapting to the new external conditions, while minimizing the potential for short-term negative effects of domestic reforms.

Adapting to the end of the commodity supercycle will require further efforts to diversify the economy away from copper. By targeting better infrastructure and greater human capital, the authorities' reform agenda is an essential component of a diversification strategy. But more is needed to boost innovation and productivity, and while the authorities have put in place a series of promising initiatives in this area (such as "*Start-up Chile*", a program that provides seed money to start-ups) there is room to expand and rationalize the programs, as well as to strengthen collaboration between firms and universities and other research institutions to increase research and development activities.

At the same time, boosting short-term growth will require nurturing the return of business confidence. While certain short-term costs of reforms are inevitable, others can be mitigated or eliminated by careful policy design. For instance, while greater unionization and more extensive collective bargaining may help reduce wage inequality and promote social dialogue, changes in labor market institutions should not happen at the cost of reducing labor market efficiency. The education reform should be pursued with a view to raising the quality of Chile's human capital, increasing productivity, and lowering income inequalities, taking into account the effects that free tertiary education may have on income distribution and the budgetary position. And the roadmap of the future constitutional reform could be further clarified.

Regaining confidence and establishing broad support for the government's reform agenda will help ensure a stronger and more inclusive economic growth for Chile.

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Luc Eyraud is a Senior Economist in the Southern American Division of the IMF's Western Hemisphere Department, where he is desk economist for Chile and Argentina. His previous assignment was in the Fiscal Affairs Department, where his work focused on the reform of fiscal institutions. Prior to joining the IMF, Luc was a civil servant at the French Treasury in the International Affairs Department.

Lusine Lusinyan is a Senior Economist in the IMF's Western Hemisphere Department, working on the Argentina desk, and, prior to this, on Canada and the United States. She was previously in the IMF's European Department, working on the Italy desk, and Fiscal Affairs Department. Her recent research has focused on structural reforms, productivity, energy issues, and fiscal decentralization.

Marika Santoro is an Economist in the IMF's Western Hemisphere Department. While at the IMF, she contributed with studies on devaluation in a small open economy, fiscal issues for commodity exporters and economic impact of structural reforms. Before joining the IMF, she was a senior economist at the U.S. Congressional Budget Office, where she published in the fields of dynamic fiscal policy and tax economics.