CHAPTER 2.3

# Chile: The Next Stage of Development

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Chile has made impressive strides during the past decade and a half in laying a foundation for macroeconomic stability.[1] Not only has inflation fallen sharply from the double-digit levels seen in the early 1990s, but a wide range of reforms has been put in place aimed at reducing the role of the state in the allocation of resources, and, more generally, supporting a process of modernization of the economy. The approach has been broad-based, left no major areas unaffected, and has included reforms in the pension and tax systems and the capital markets, trade liberalization, the functioning of the labor market, a significant curtailment in the level of government intervention through subsidies and deregulation, and privatization of state enterprises and social security. These reforms have greatly enhanced the flexibility of the Chilean economy and contributed to sustained increases in output and per capita income (Table 1). During the twenty-year period ending in 2003 Chilean GDP per capita rose by close to 270 percent, three times faster than the average for Argentina, Brazil and Mexico, the three largest economies in Latin America (Figure 1).[2] Indeed, to find other countries with a comparable (or better) growth performance one is forced to look much farther, to the likes of Korea and Ireland, impressive success stories in their own right (Figure 2).



## A case of special interest

From the perspective of the World Economic Forum, there are several reasons why the recent Chilean economic experience is of special interest and worth highlighting. The competitiveness indicators constructed at the Forum show that not only is Chile the best performing economy in Latin America, but the gap in rankings between Chile and its closest competitor, Mexico, is 26 places. We do not see this huge gulf anywhere else in the world, for the 104 economies for which these indicators are estimated. In fact, for all the regions of the world, what is evident is that economies tend to cluster together, with a top regional performer, followed closely by others, in quick succession. The top quartile of the 104 countries ranked in this year's *Growth Competitiveness Index* (see Chapter 1.1 and the Executive Summary) contains 14 European economies; the bottom quartile contains a large cluster of economies in Africa. Chile, figuratively speaking, in terms of macroeconomic management and performance, seems to have "migrated" from Latin America, and joined a group made up by countries such as New Zealand, Israel, Spain, and Portugal.[3]

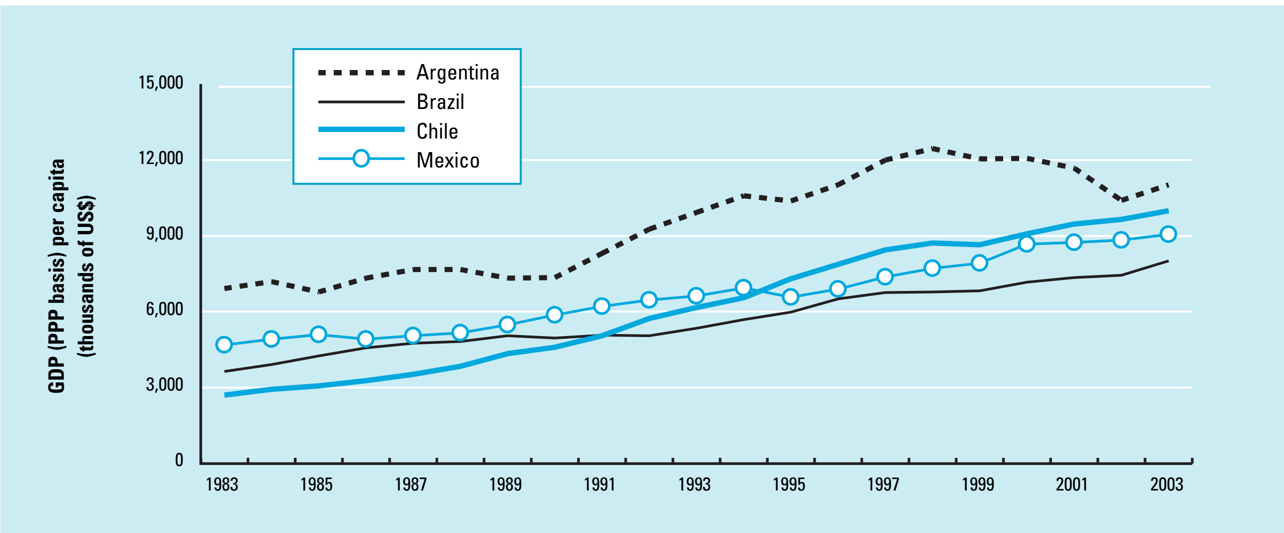
This observation has a significance that goes well beyond Chile. The last several years have witnessed an erosion of public support for economic reforms in much of the developing world. With the possible exception of the economies of central and eastern Europe, which have

## Table 1: Chile: Selected economic indicators

| | 1986–1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Inflation (eop)[1] | 19.4 | 21.8 | 15.4 | 12.7 | 11.4 | 8.2 | 7.4 | 6.1 | 5.1 | 3.3 | 3.8 | 3.6 | 2.5 | 2.8 | 1.3 |
| GDP growth[2] | 6.8 | 8.0 | 12.3 | 7.0 | 5.7 | 10.8 | 7.4 | 6.6 | 3.2 | –0.8 | 4.2 | 3.7 | 2.2 | 3.3 | 4.6 |
| Fiscal deficit[3] | 1.2* | 1.6 | 2.3 | 2 | 1.7 | 2.6 | 2.1 | 1.8 | 0.4 | –1.4 | 0.1 | –0.3 | –0.8 | –0.5 | 0.4 |
| Public debt[4] | 69.6 | 38.8 | 31.7 | 29.2 | 23.5 | 17.9 | 15.1 | 13.2 | 12.5 | 13.8 | 13.7 | 15.0 | 15.7 | 13.3 | — |
| Current account balance[5] | –2.8 | –0.3 | –2.3 | –5.7 | –3.1 | –2.1 | –4.5 | –4.9 | –5.4 | 0.1 | –1.0 | –1.8 | –0.9 | –0.8 | –0.2 |
| Interest rate (%)[6] | — | — | — | 8.0 | 13.9 | 6.1 | 7.3 | 6.9 | 9.0 | 5.9 | 5.3 | 5.1 | 4.1 | 2.7 | 1.8 |

* Data available only from 1989–1990.
1 Inflation, annual percent change, IMF, *World Economic Outlook (WEO) database*, April 2004.
2 Gross domestic product, constant prices, annual percent change, WEO *database*, April 2004.
3 Percent of GDP, *Economist Intelligence Unit*.
4 Central Bank of Chile. For 1986-1988, the domestic component of total public debt is estimated.
5 Current account balance in percent of GDP, WEO *database*, April 2004.
6 Central Bank of Chile refinance rate; for 2004, average of monthly rates through June.

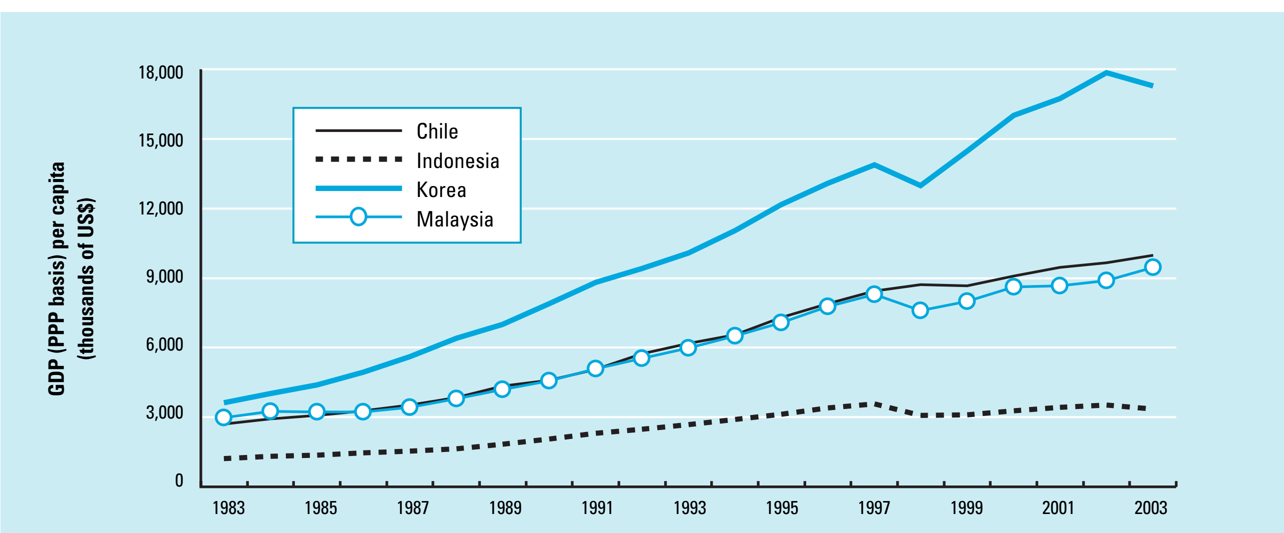
## Figure 1: Chile and other Latin American economies: GDP per capita, 1983–2003




Source: IMF *World Economic Outlook*



## Figure 2: Chile and East Asian economies: GDP per capita, 1983–2003




Source: IMF *World Economic Outlook*

made impressive gains during the past 15 years—in the context of a well formulated and generously financed program of reforms, aimed at ensuring successful accession to the EU—and some of the Asian economies, which have grown quickly in recent years, support for reforms, i.e. macroeconomic discipline, the institutions of a market economy, and openness to the world, has suffered in Latin America, in much of Africa, and in India.[4] In some countries, "withered" might be a more accurate term. Some of this can be explained in terms of disappointment with a sluggish growth performance, which has prevented countries from making greater progress toward job creation and poverty reduction. If market reforms do not translate into increased opportunities for the public, along with a narrowing of income differentials, it is perhaps not surprising to see restlessness and skepticism at the grass roots level. The erosion of support for market reforms, however, also reflects a certain sense of frustration with the rapid pace of change in the global economy, which, while it creates opportunities for the agile and nimble, seems to leave others behind, unable to compete in the increasingly global marketplace. Populism would surely not be making a comeback if the fruits of development had not been so distressingly disappointing in so many parts of the world.

What the Chilean experience shows is, first, that good policies matter a great deal. Yes, many countries in the developing world are not much better off today than a decade ago. Indeed, in much of Africa, they are worse off. Others, such as Argentina, Brazil, Russia, Turkey, to name a few of the more conspicuous emerging markets, have had a rough ride, and performance has been rather mixed—successes in some areas, offset by setbacks in others and, along the way, considerable volatility, along with the associated political risks.[5] However, the culprit for the poor results has apparently little to do with the virtues of macroeconomic discipline and/or the benefits of liberalization and increased transparency, and may have a great deal more to do with reforms that are incomplete, mutually inconsistent, poorly implemented, or some combination of all the above. Second, policymakers may indeed be operating in a framework of narrowing choices, for globalization and the emergence of an integrated global economy has greatly reduced the ability of government authorities to control the policy environment or, as Richard Cooper (1988) put it: "the increasing internationalization of the economy has led to an erosion of our government's capacity to do things the way it used to."[6] However, even within this narrower (and narrowing) environment, the scope for policy missteps is huge. It is clear that sound policies will still go a long way toward creating the conditions for rapid growth, and protecting countries from the shocks and uncertainties associated with an increasingly complex international economy.

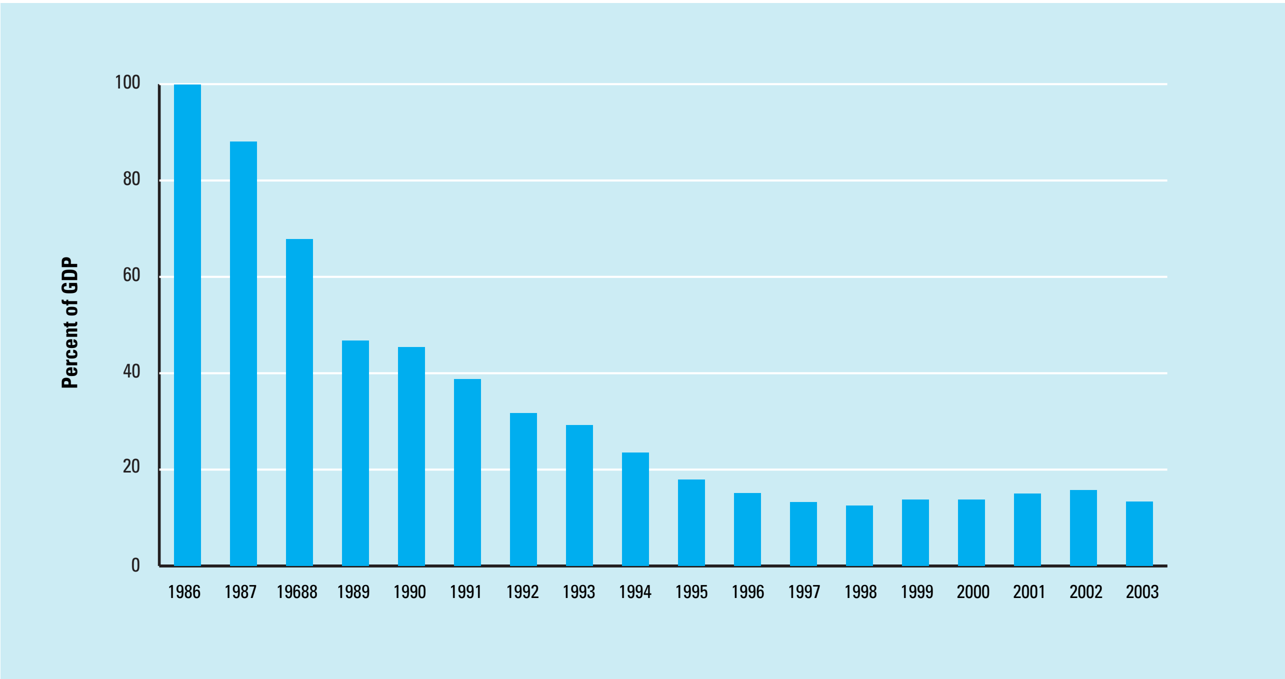
In the sections below, we will look, from the perspective of the World Economic Forum—shaped to a large degree by the insights of the international business community, including some of the world's top foreign direct investors—at those factors which make Chile an exceptional case in the developing world. We will then focus on some of the key challenges facing policymakers in the period ahead, both to preserve the gains made during the past two decades, and to create the conditions for the next stage of growth and development. A final section will identify some risks and possible sources of vulnerability, and the measures that might be necessary to mitigate their effects.

### What makes Chile exceptional?

The list of factors which explain Chile's strong growth performance during the past 20 years is rich and long. It is outside the scope of this paper to enumerate them all, or to assess the role each has played in the establishment of a macroeconomic and institutional foundation of stability. For instance, the reforms which have gradually been implemented in the banking, pension and insurance sectors, complemented by the introduction of a tough regulatory and supervisory framework for financial institutions, has played a key role in deepening Chile's capital markets, expanding the investor base and creating a stable, predictable environment for financial intermediation, characterized by good corporate governance and transparency, and by improved access to financial resources for small firms. A fully independent central bank has played an essential role in buttressing the credibility of Chile's monetary policy, and deserves credit for its careful handling of the inflation-targeting regime and resulting excellent inflation performance.

However, there are three particular areas where progress has been truly remarkable and where, in our judgement, the Chilean experience is especially noteworthy. Our choice of these three factors is inevitably shaped by the World Economic Forum's international perspective. While vertical comparisons of a country's trajectory over time are interesting—and we applaud when countries improve performance with respect to their own respective histories—we have a preference for horizontal comparisons across many countries, at a given moment in time. This predilection lies at the heart of our work on competitiveness, which aims to present a cross-section of countries' relative strengths and weaknesses in a given year.[7] In the sections below, we focus on the roles of fiscal discipline, the openness of the trade regime, and aspects of public sector governance and political economy.

**Figure 3: Chile: Public debt 1986–2003**




Source: Central Bank of Chile



## An enviable fiscal policy

Few things say more about the quality of a country's leadership and the effectiveness of its institutions than the state of its public finances. The budget is not only the main instrument of distribution in an economy but, in the final analysis, is also a mirror that reflects the myriad compromises implicit in the political process, the maturity of its leaders, the technical expertise of its bureaucrats, and even the state of the external environment. Argentina, Russia, and Turkey would surely not have plunged into deep financial crises in recent years, if the authorities had been able to manage the public finances with a modicum of restraint.[8] Failure to do so led to the collapse of their respective exchange rate regimes, banking systems, output, and, in all cases, sooner or later, respective governments. And the curious debate taking place within the EU on the future of the Growth and Stability Pact would not have taken an occasionally surreal tone had it not been for the failure of some of the EU's largest members to rein in public spending.

Chile is part of a small group of countries in which the political process has resulted in broad-based support for fiscal discipline, where safeguards have been introduced, which effectively insulate the budget from the venality of politicians, and from the diverse demands placed upon it by economic agents in a pluralistic democracy. The net effect has been a virtuous fiscal policy, which has contributed to a sustained reduction in the levels of public debt, from close to 100 percent of GDP in the mid-1980s, to less than 14 percent of GDP in 2003 (Figure 3).

We find no example, either among industrial countries or in the developing world, with as sustained a downward adjustment in debt levels as in Chile; in fact, quite the opposite is the case. The vast majority of OECD members have higher levels of public debt today than 10 years ago. This, in turn, has greatly reduced the debt-servicing burden of the public debt in Chile, contributed to sharply lower interest rates, and to the highest credit ratings in Latin America. A lower debt burden has, of course, allowed spending to rise in other areas, including education and public health, and is very much behind the progress made in reducing the incidence of poverty, which fell from 38.6 percent in 1990 to 18.8 percent in 2003, the most recent year for which the information is available.

Chile's institutional framework for implementing fiscal policy has a number of noteworthy features. These include a prohibition on public sector borrowing from the central bank, in addition to a prohibition on the issuing by municipal governments of debt or borrowing. In addition, the budget process is led and effectively dominated by the Executive and, within it, by the Ministry of Finance. If a draft budget submitted by the government to Congress is not approved within 60 days, the draft automatically becomes law in the absence of satisfactory resolution of

Table 2: Chile: Merchandise exports 1975–2003 (millions of US dollars)

| | 1975 | 1980 | 1985 | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|
| Total exports | 1,590 | 4,705 | 3,804 | 8,373 | 16,024 | 19,210 | 18,272 | 18,177 | 21,046 |
| Mining | 1,111 | 2,952 | 2,262 | 4,361 | 7,422 | 8,021 | 7,256 | 7,074 | 8,461 |
| Copper | 868 | 2,125 | 1,789 | 3,810 | 6,487 | 7,285 | 6,537 | 6,282 | 7,503 |
| Agriculture and fisheries | 84 | 340 | 515 | 995 | 1,566 | 1,693 | 1,727 | 1,764 | 1,977 |
| Food, beverages and tobacco | 107 | 397 | 421 | 1,241 | 2,837 | 3,226 | 3,345 | 3,572 | 4,025 |
| Forestry and furniture | 25 | 286 | 112 | 370 | 735 | 934 | 1,014 | 1,154 | 1,268 |
| Cellulose, paper and derivatives | 100 | 297 | 210 | 423 | 1,542 | 1,405 | 1,122 | 1,118 | 1,236 |
| Chemical products | 46 | 163 | 96 | 308 | 596 | 1,217 | 1,338 | 1,291 | 1,745 |
| Other | 118 | 270 | 188 | 675 | 1,326 | 2,714 | 2,471 | 2,205 | 2,335 |

Source: Central Bank of Chile

any disagreements. Since March of 2000 the government has moved to a regime whereby it targets the central government's structural balance. That is, the level of government expenditure is limited to the level of structural (i.e. cyclically adjusted) revenue. In practice, this means that procyclical policies are altogether avoided. Neither government expenditures nor tax rates move to offset temporary changes in output and copper prices. What in fact does adjust is the actual government balance, for which there is a target of a surplus of 1 percent of GDP on average. This approach to fiscal policy has a number of distinct advantages: it depoliticizes the budget process from election cycle spending (or other politically motivated discretionary spending); it thus establishes a smoother profile for government expenditure, which, in turn, allows the government to implement a predictable public investment program. By institutionalizing fiscal discipline, an environment is created in which, in the absence of an exchange rate target, monetary policy is enabled to play an effective countercyclical role.

### Cautious integration with the global economy

Chile's trade regime, one of the world's most liberal and transparent, has a number of features which are worth highlighting. First, some of its building blocks—such as a total ban on non-tariff barriers—have an unusually strong legal underpinning, "a quasi-constitutional status, being embodied in the Basic Constitutional Act of the Central Bank" (IMF, 2004). A uniform tariff limits the scope for lobbying, and the process of tariff-setting itself, often in the hands of the Executive in other countries, involves Chile's Congress. Tariff levels have been brought down unilaterally from 15 percent in the early 1990s to 6 percent by the end of 2003 but, in practice, because of free trade agreements accounting for a significant share of total Chilean trade, an effective 2 to 2.5 percent. In the past decade, the focus of trade policy has shifted to the negotiation of regional free trade agreements, aimed at opening new markets for Chilean exports, and as complements to ongoing multilateral efforts for trade liberalization in the context of the WTO. Following a free trade agreement with Canada in 1996, free trade agreements were concluded during the period 2002–2003 with the United States, the European Union, Korea and the European Free Trade Association (EFTA), blocs which account for half of total Chilean exports.[9] The motivation behind these deals has been multipurpose: to improve market access for Chilean exports, to forestall protectionist measures in other countries, and to encourage further diversification of exports toward products with higher value added.

The value of Chilean exports has more than quadrupled since 1980, reaching some US$21 billion in 2003, a double-digit annual rate of volume growth (Table 2). Exports of goods and services have contributed, on average, about 2.5 percentage points to GDP growth during the period 1990–2003. While the structure of exports remains heavily dominated by natural resources, there has been gradual diversification during the past 30 years, and a steady rise in the share of processed natural resources and other industrial products, which now account for some 50 percent of total exports (Figure 4).[10]

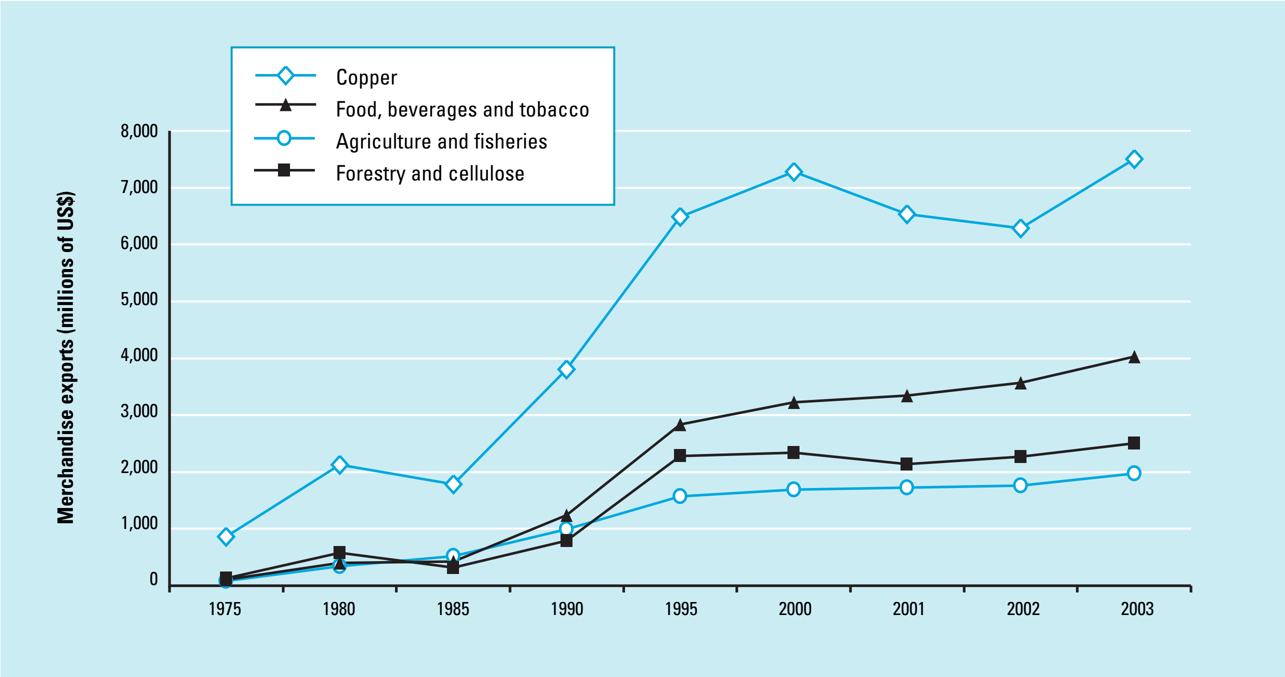
Chile has made particularly impressive strides in the forestry, agro-industry and fishing sectors, becoming, in the latter case, one of the world's largest exporters of salmon, a virtually non-existent industry in the mid-1980s. The development of both the salmon and wine industries is a particularly good example of the profitable reunion of comparative advantage, advanced technology, foreign investment, knowledge and innovation, to enhance value added and export diversification.

Nevertheless, while the ratio of exports to GDP in Chile is high by regional standards, it is still well below the corresponding ratio in some of the fastest growing economies in Asia and central and eastern Europe. Chile's relative geographical isolation notwithstanding, there is no reason why the export to GDP ratio could not rise significantly in coming years, pari passu with an increase in the technological content of its exports (see Figure 4).

### Public sector governance

The key role played in the development process by public institutions and the quality of government is by now

**Figure 4: Chile: Merchandise exports**




Source: Central Bank of Chile



universally acknowledged. Insights into the mechanisms by which governments can be either catalysts for progressive change or agents of destruction reflect, to a great extent, painful empirical observation, collected over more than half a century of development experience, in virtually every corner of the world.[11] The evidence on the quality of public institutions collected by the World Economic Forum's Executive Opinion Survey—to name one such source—unambiguously suggests, that it matters a great deal for successful development whether (a) governments are accountable to their respective populations, (b) the press operates in an environment that encourages public discourse, without fear of retaliation, (c) scarce public funds are not diverted to corrupt ends, and (d) investors are able to obtain legal redress in the context of a reasonably transparent, honest, judicial system. Even in those countries where democratic institutions are firmly entrenched, and where safeguards are in place to protect the business environment from arbitrariness and abuse, the role of public institutions is still central in fostering a climate conducive to growth and competitiveness.

Laudable as Chile's approach to managing its public finances or establishing an open trade and investment regime have been, we find the achievements in the area of public governance particularly noteworthy. There are at least three aspects that we would like to highlight.

### Low levels of corruption

Chile ranks 20th among 133 countries in Transparency International's Corruption Perceptions Index 2003, ahead of Japan (21), France (23) and Spain (23) and far ahead of Italy (35), Brazil (54), Mexico (64) and Argentina (92). In fact, the 19 countries with a better score than Chile are all high-income countries, as defined by the World Bank. In the World Economic Forum's own Corruption subindex, part of the *Growth Competitiveness Index (GCI)*, Chile ranks 15 out of 104 countries in 2004. Indeed, of the three subindices which go into the computation of the overall GCI, the highest ranking for Chile corresponds not to the macroeconomic environment index, but to the public institutions component, which links measures of corruption together with contracts and rule of law.

### Legitimization of reforms

Market reforms in Chile have been legitimized in the eyes of the public, because they have benefited the population in tangible ways, as noted above, for instance, by increases in per capita income or sustained reductions in poverty levels. Contrast this with the experience of other countries where many of these reforms, particularly privatization, have often led to the spawning of corrupt elites.[12] In addition, on those occasions when flaws in the public administration have emerged—for instance in late 2002, in connection with remuneration mechanisms for senior

**Table 3: Doing business in Chile in 2004**

| | Starting a business | | | Enforcing a contract | | |
|---|---|---|---|---|---|---|
| | Number of procedures | Time[1] | Cost[2] | Number of procedures | Time[1] | Cost[2] |
| Argentina | 15 | 68 | 8.0 | 32 | 300 | 8.5 |
| Brazil | 15 | 152 | 11.6 | 16 | 380 | 2.4 |
| Chile | 10 | 28 | 11.6 | 21 | 200 | 14.7 |
| Colombia | 19 | 60 | 27.2 | 37 | 527 | 5.9 |
| Costa Rica | 11 | 80 | 21.4 | 11 | 80 | 21.4 |
| Denmark | 4 | 4 | 0.0 | 14 | 83 | 3.8 |
| Finland | 4 | 33 | 3.1 | 19 | 240 | 15.8 |
| Ireland | 3 | 12 | 10.4 | 16 | 183 | 7.2 |
| Israel | 5 | 34 | 4.7 | 19 | 315 | 34.1 |
| Mexico | 7 | 51 | 18.8 | 47 | 325 | 10.0 |
| New Zealand | 3 | 3 | 0.2 | 19 | 50 | 11.6 |
| Portugal | 11 | 95 | 12.5 | 22 | 420 | 4.9 |
| Spain | 11 | 115 | 18.7 | 20 | 147 | 10.7 |
| Sweden | 3 | 16 | 0.8 | 21 | 190 | 7.6 |
| Venezuela | 14 | 119 | 19.3 | 41 | 360 | 46.9 |
| Sample average | 9 | 58 | 11.2 | 24 | 253 | 13.7 |

1 Time measured in days
2 Cost measured as percent income per capita
Source: *Doing Business in 2004*, World Bank

officials, or in connection with financing of political parties—the response has been swift and effective. Chile today has a demanding campaign contributions law and, along the way, the government has greatly reduced the number of officials who may be appointed at the discretion of the President upon taking office, an important step forward in the area of public sector reform.

### Building consensus

A government's ability to generate a broad consensus for change is a central ingredient of sustainable economic reforms. Successive governments since 1990, following the country's return to democracy have, to a greater or lesser degree, been fairly successful in setting in motion processes of consultation, to elicit the views of various sectors in society, such as opposition political parties, trade unions, various organizations of civil society. This has resulted in greater understanding of and commitment on the part of the population to the often painful measures that accompany the implementation of various economic adjustment measures. At times—as in the early 1990s when the new government sought to create room in the budget for a substantial increase in social spending—the approach taken involved a delicately balanced combination of firmness (on those issues that were central to the ultimate success of its strategy) and flexibility (when it was called for to build up critical support for its approach within the trade unions, for instance), reflecting political economy at its best. This approach has led to a more equitable distribution of the costs of adjustment and contributed to political stability.

## What are the key challenges ahead?

The central question is whether it is possible to return to the high growth rates of the period 1984–1997 and, if so, what are the policies that must be implemented in order to ensure this. Growth is important to reduce poverty further, to broaden opportunity for the Chilean population, to enable the country's citizens to gradually shift the focus of their lives from a concern with the struggle for material existence to other pursuits very much at the center of what we call "development." Three areas of emphasis come quickly to mind, two of these, having to do with the quality of Chile's educational system and current approaches to public governance are particularly central to the question of what are the key elements of Chile's next stage of development.

### Bureaucracy and red tape

The World Bank's quantitative indicators of business regulations, which attempt to provide internationally comparable information on the barriers to doing business in a large number of countries, suggest that Chile, at least in some ways, may still be in the grips of a culture of bureaucracy. Table 3 provides two sets of indicators for a group of 15 countries, both in Latin America and elsewhere in the world, including countries such as Finland, Ireland and New Zealand. The first set of numbers provides various indicators on the obstacles to starting a new business, while the second set provides similar concepts for enforcing a contract.

Chile's performance is generally better than that of other countries in Latin America, but well behind that of Denmark, Finland, Ireland and New Zealand. It takes 28 days on average to start a new business in Chile, and the

## Table 4: Average years of schooling across countries

| | Average years of schooling[1] | Secondary education[2] | Net enrollment ratio in secondary education[3] | Gross enrollment ratio in tertiary education[4] | Ratio of students to teaching staff[5] | | Educational attainment of 15 year-olds[6] | | Expenditure on education[7] | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Primary | Tertiary | Percentage at or below Level 1 | Percentage at Levels 4 & 5 | Pre-primary, primary and secondary | Tertiary |
| Argentina | 8.3 | 42 | 81 | 57 | 22.7 | 9.3 | 47.7 | 11.9 | 3.7 | 1.2 |
| Brazil | 7.5 | 26 | 72 | 18 | 24.8 | 15.2 | 67.5 | 2.6 | — | — |
| Chile | 9.9 | 46 | 79 | 37 | 33.4 | — | 57.7 | 4.9 | 4.6 | 2.3 |
| Mexico | 8.0 | 22 | 60 | 20 | 27.0 | 15.2 | 51.7 | 7.0 | 3.8 | 1.1 |
| New Zealand | 12.1 | 76 | 92 | 72 | 19.6 | 15.0 | 14.2 | 47.4 | 4.6 | 0.9 |
| Denmark | 12.2 | 80 | — | 59 | 10.0 | — | 19.3 | 31.9 | 4.2 | 1.6 |
| Spain | 9.5 | 40 | 94 | 57 | 14.7 | 13.4 | 20.3 | 23.0 | 3.3 | 1.1 |
| Finland | 11.7 | 74 | 95 | 85 | 16.1 | 16.8 | 7.9 | 53.8 | 3.5 | 1.7 |
| Ireland | 10.2 | 58 | 82 | 47 | 20.3 | — | 12.7 | 41.0 | 3.0 | 1.5 |
| Israel | — | — | 89 | 53 | 20.1 | 16.0 | 40.4 | 16.9 | 4.7 | 1.9 |
| Portugal | 7.3 | 20 | 85 | 50 | 11.6 | — | 32.1 | 19.2 | 4.1 | 1.1 |
| Thailand | 7.5 | 38 | — | 37 | 20.4 | 27.1 | 49.9 | 4.3 | 2.9 | 0.9 |

1 For population aged 15–64 not studying (2000). OECD Development Centre, Technical Papers, No. 179.
2 Population share that has attained at least upper secondary education in the age group 25–64 years (2001). OECD, Education at a Glance 2003.
3 For 2001–2002. UNESCO Institute for Statistics, Montreal, Global Education Digest 2004, Comparing Education Statistics Across the World.
4 The World Bank, World Development Indicators 2004, for 2001–2002.
5 In public and private institutions by level of education based on full-time equivalents (2001). OECD, Education at a Glance 2003.
6 Percentage of students at different levels of proficiency on the combined reading literacy scale (2000). OECD, Literacy Skills for the World of Tomorrow. Further Results form PISA 2000.
7 From public and private sources, as a percentage of GDP by level of education (2000). OECD, Education at a Glance 2003.
— denotes data missing



cost of doing so is about 11.6 percent of income per capita. However, it takes three days to open a new business in New Zealand and, for all practical purposes, the cost of doing so is zero. For all the talk about the need to nurture a vibrant private sector, the evidence suggests that Chile can do more to reduce bureaucracy and red tape. No doubt, there has been remarkable progress in this area in the past decade, but the scope for additional gains appears to be large. To the extent that the bulk of these restrictions are self-imposed, this would appear to be one area in which gains could be made relatively quickly and painlessly.

### Improving the quality of Chilean education

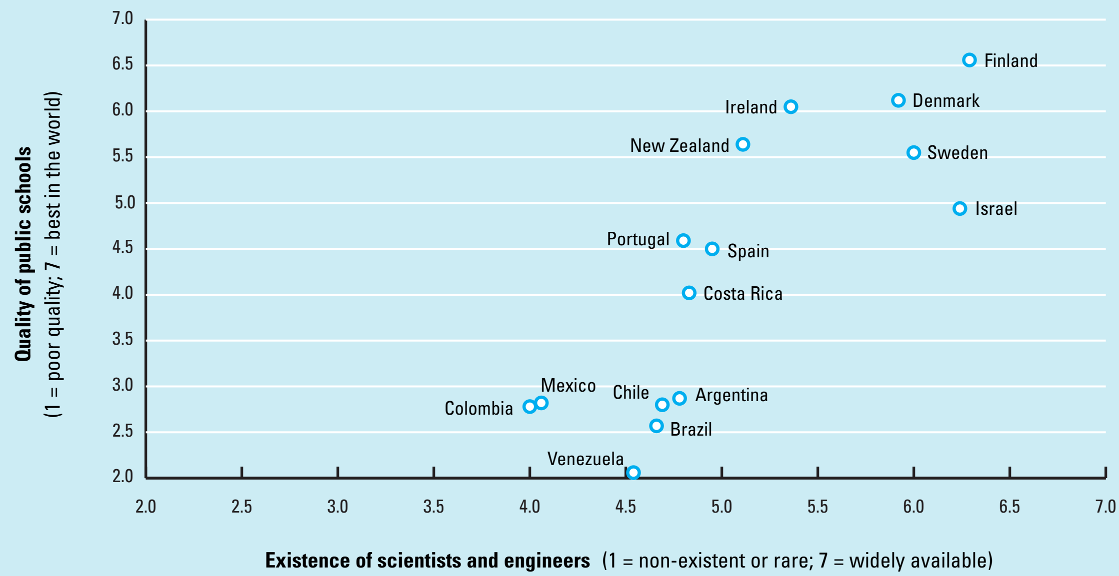
Chile has made considerable gains in the past 40 years in boosting the educational attainment of its labor force. The average number of years of schooling for those aged 15–64 is at present around 10 years, more than twice the level of 1960 and, by now, higher than in Spain and Portugal (Table 4).

The gross enrolment ratio in tertiary education, according to the World Bank's *World Development Indicators 2004* is 37 percent, double the level of 1980 and many times higher than in 1960. Expenditure on education, from public and private sources, in percent of GDP, for pre-primary, primary and secondary education stands at about 4.6 percent of GDP, equal to New Zealand, and higher than in Denmark, Finland and Ireland. And, at the tertiary level of education, at least for the countries in Table 4, Chile spends more than any other country in relation to GDP.[13] So, on the face of it, reflecting these impressive trends, the educational achievement and level of preparedness of its population should be catching up with the OECD average.

Regrettably, nothing could be further from the truth. An OECD study on adult literacy skills showed that fully 57 percent of Chile's labor force has a low level of basic reading comprehension. Only 4.9 percent achieved levels 4 and 5.[14] Contrast these results with those of Finland and New Zealand, which are precisely the reverse: roughly 50 percent of the labor force are at levels 4 and 5. In international test results assessing achievement in mathematics and science, Chile ranked 35th among 38 participating countries, as noted in World Bank (2004). Chile produces about 120–130 Ph.D.s per year, compared to about 1,000 in the smaller and more competitive European economies, such as Denmark. These results are largely corroborated by survey data, such as that collected by the World Economic Forum through its Executive Opinion Survey. Survey questions which attempt to assess the ability of the educational system to meet the needs of a competitive economy, the quality of the public schools, and the quality of math and science education, put Chile firmly in the bottom half among the 104 countries surveyed (Figure 5).

The nurturing and efficient utilization of a nation's human capital is increasingly seen as the main channel to enhance the ability of a country to carry out technological innovations which could boost growth. In their work on technological advances and the stages of development, Sachs and McArthur (2002) emphasized that the role of technology in the growth process differs for countries,

**Figure 5: Chile: Quality of schools and availability of scientists**




Source: Executive Opinion Survey 2004



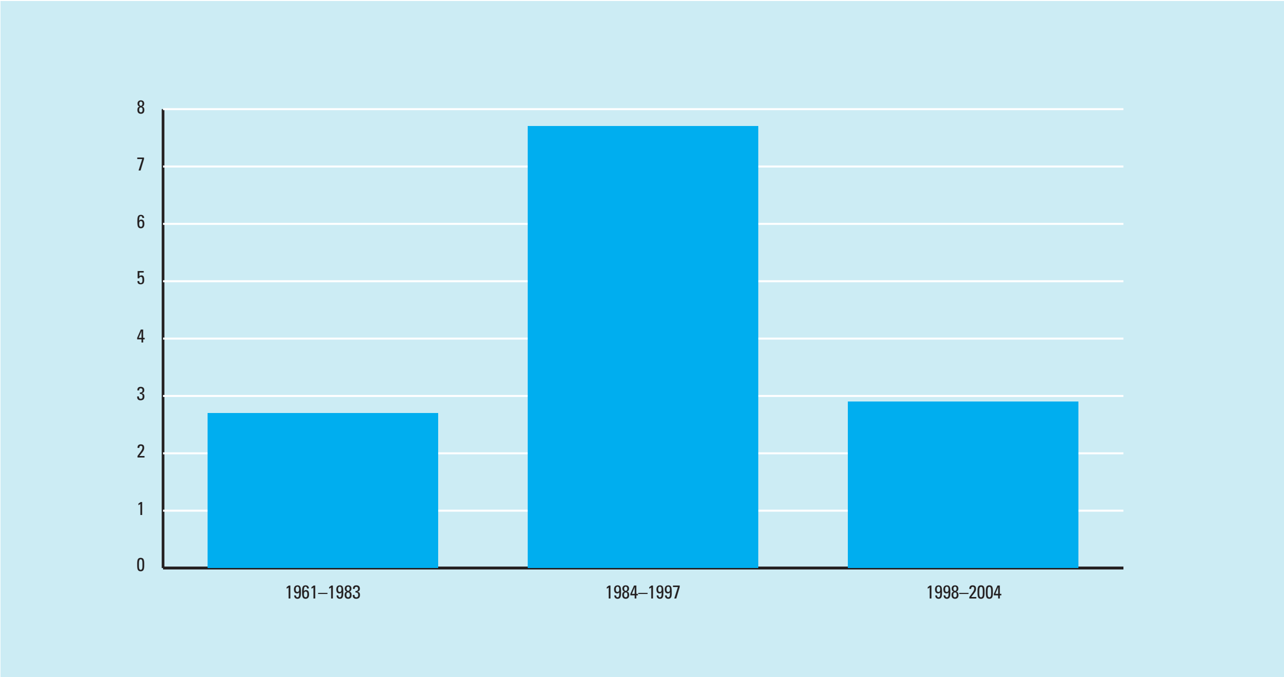
depending on whether they are operating close to the technological frontier. Innovation will be key in countries like Finland, but the adoption of foreign technologies—or the kind of technology transfer that is frequently associated with foreign direct investment—will be relatively more important in countries like Chile. For "non-core" economies such as Chile's, still at the relatively early stages of technological innovation, growth performance is likely to depend much more on the quality of institutions and the macroeconomic environment. Typically, countries will not yet have entered a period of "diminishing returns" by getting their macroeconomic and institutional fundamentals in order.

Countries with important deficiencies in their macroeconomic frameworks, or which are still characterized by the existence of distortions and other rigidities, will benefit from improvement in the quality of public sector institutions, from the elimination of such distortions, and from improvements in transparency. Indeed, this explains, to a large extent, the excellent growth performance in recent years of the economies of central and eastern Europe, for example, and, to some extent, Chile's own impressive growth performance during the period 1984–1997 (Figure 6).

On the other hand, for the "core" economies, that is, those that are near the technological frontier, technology and innovation will be much more important. These economies will typically have long ago entered a period characterized by "institutional stability." Improvements at the margin from one year to the next are unlikely to boost growth rates in a tangible way. For these countries to continue to grow, they must innovate, and to innovate successfully, they must have a world-class educational system.

There is an interesting debate in Chile as to the factors underpinning the recent deceleration of output shown in Figure 6. There is no doubt that a combination of many factors is surely at work, including the impact of the 1997–1998 Asian financial crisis which hit Chile with some force—reflecting the country's growing trade linkages with the region—the slowdown in world stock markets in early 2000, and the drying up of capital flows to emerging markets. We have some sympathy for the view that the GDP slowdown in 1998 and the downturn in 1999 may have also reflected some overshooting of interest rates, as the central bank, consistent with its mandate, sought to dampen inflationary pressures.[15] However, the role of external factors should not be overemphasized. The hardest hit economies in Asia have bounced back, and the average growth rate during the period 2000–2003 for Korea, Malaysia and Thailand was 5 percent, compared to 3.8 percent in Chile. A more compelling explanation may be provided by the arguments put forth by Sala-i-Martin and Artadi (see Chapter 1.3 in this *Report*), which are an

**Figure 6: Chile:GDP growth (annual percent)**




Source: *World Development Indicators 2004*, World Bank



extension, in spirit, of the arguments referred to above by Sachs and McArthur and, over the years, by Porter (2003).

Applied to Chile, the argument would run as follows: having long ago graduated from the "factor-driven" stage of development, where countries grow and stay competitive by taking advantage of low labor costs and cheap unprocessed natural resources, Chile is now making its way through the "efficiency-driven" stage of development. In this stage, the key drivers of growth are improvements in the efficiency of goods, labor and financial markets, as well as the absorption of technologies developed elsewhere. Those economies in this stage which manage to access larger markets by opening up their economies—as Chile has done so successfully—will benefit from the associated economies of scale. However, at some point, the country will enter a period of "diminishing returns."[16] Macroeconomic discipline, institutional stability and transparency, to name a few such factors, will have become an established feature of the business environment, and while marginal improvements in these areas will always be possible, the extra benefits likely to be associated to them will be small. The sources of growth will then shift to the production of other goods, with a much larger technological component, and involving elements of innovation; at this point, the country will be ready to enter the "innovation-driven" stage. Success in this area will depend critically on a highly skilled labor force, as can be found in Finland, Ireland and New Zealand (see Table 4).

It is outside the scope of this paper to come up with a list of recommendations on how to improve Chile's educational system. It is clear that the key issue is not one of the adequacy of resources, but rather how to improve their efficiency. Progress in this area is likely to entail modernizing curricula, improving teachers' training and bringing on stream performance criteria to assess competence, enhancing preschool education, launching a well funded campaign to increase English literacy[17] or a combination of all of the above, and much more. We find it paradoxical that while successive governments since 1990 have managed to reimpose a greater degree of civilian control over Chile's military—as could not be otherwise in a fully developed democracy—they have been considerably less successful in dealing with teachers' trade unions.[18] The costs of inaction in this area are likely to be large. In today's global economy, countries that stand still, by definition, fall behind. At some point—if it is not happening already—lack of progress in significantly upgrading Chile's educational system will be a major drag on the Chilean economy.

## Rethinking the role of the state

During the past twenty years, there has been a major redefinition in Chile of the role of the state in the economy. Briefly stated, it has involved a gradual shift in emphasis, reducing the presence of the state in the production of goods and services and enhancing its distributive attributes and, most importantly, its role as the chief promoter of a simple regulatory framework based on transparent rules. The full independence given to the Central Bank of Chile in 1989, and the admirable fiscal rules under which the present government has been operating are very much part of this approach: reduce the scope for discretion, limit the ability of future politicians to tamper and misuse the system for political ends, or worse, for personal gain, and protect what has been achieved through years of painstaking effort from the vagaries of political cycles and/or the caprice of demagogues. Clearly, the system that has been erected seeks to protect the public interest, whose ultimate welfare the elected politicians and civil servants are expected to serve. Given the abuses and missteps seen elsewhere in the region during the past two decades, it is not surprising that Chileans overwhelmingly prefer the political and economic system that has emerged in their land to the alternatives tried in neighboring countries.

However, times change and successful societies must keep under constant review even their most cherished habits and traditions, lest, imperceptibly, they acquire the status of rigid dogma. The main challenge confronting policymakers in Chile is how to take the country to the next stage of development, how to unleash a process of rapid growth, such as that seen in Ireland during the past 15 years, or the technological transformation seen in Finland in the wake of the collapse of the Soviet Union. New Zealand is a good example, too, with its impressively efficient public institutions. The central role of education, and the need for a quantum improvement in the quality of Chile's educational system has already been alluded to. Chile should design a long-term educational campaign, aimed at significantly narrowing the gap with Finnish education indicators by 2020. There is nothing in the reform agenda of the next decade that comes even close in importance to this. Future Chilean leaders are likely to be judged by history on the extent to which they galvanize the population and the business community to the achievement of this aim.

Like Chile, Finland also has a well run macroeconomy. Reflecting a longer tradition of democracy and political stability, Finland—according to the indicators put together by Transparency International—is the least corrupt country on earth. And yet, one cannot fail to observe the extent to which the public sector in Finland has played an active role in promoting, financing, and in directing the wave of technological innovation, which has turned the country into a world leader in the telecommunications industry. Whereas in Chile the government is prohibited by law to provide capital to new businesses and provides, most sparingly and occasionally, matching grants for startups and other incentives for new ventures, the Finnish government, in contrast, is very active in this area.[19] It is as though the Finns have such supreme self confidence in the honesty of their politicians and public servants that they do not see fit to tie their hands and reduce their room for manoeuvre, in those few instances where it might actually make sense for the public sector to be involved in some key component of a strategy aimed at boosting the country's technological potential or its innovation capacities.[20] The two central questions here are: first, at what point in its development does a country cross the threshold, when it has enough confidence in the maturity of its institutions (including the press) and the integrity of its politicians and businesses to introduce a degree of flexibility in some elements of its approach to management of the economy; second, has Chile crossed that threshold? The answer to this last question only Chileans themselves can provide, through a process of national consultation.

### Risks and vulnerabilities

We have already alluded to the potential risks associated with failure to boost the quality of Chilean education. Clearly, this is a challenge well within the sphere of influence of the authorities, and will require a proactive agenda, as well as the willingness to forge a national consensus for reform and modernization, lest Chile finds itself at the outset of the 21st century with a labor force that does not adequately meet the demands of an increasingly complex global economy. We would like to highlight two additional risk factors, one domestic and one external.

#### Insufficient diversification

The thinking here is as follows. Chile has been tremendously successful in building an export-based development strategy firmly anchored in its comparative advantages. This has led to an excellent overall growth performance in the past 20 years, which has not only permitted the rapid growth of incomes, but also allowed a gradual reduction in the incidence of poverty.[21] Therefore, Chile does not need to veer sharply off course. It should continue to do the same things, only do them better. So, the next stage of development should involve the emergence of clusters around natural resources and their processing, and the upstream development of supporting industries. The sectors for cluster development are obvious: mining, forestry, fishing and agriculture, where a combination of high technology and comparative advantages will add to processing and value added. In this scenario the role of Fundación Chile, a private nonprofit organization, which has had some impressive successes in encouraging the adoption of new commercial technologies in sectors with cluster potential, would become even more central. In other words, the next stage of development involves the Nordic model, adapted to local conditions, minus the welfare state. In principle, there may be nothing wrong with this approach, which, broadly speaking, does not exclude the possibility of incursions into other areas, as Costa Rica, an exporter of coffee and bananas during much of the past half century, has been able to do successfully in recent years, with the development of an electronics and information technology cluster.

One potential problem with this scenario is that as long as natural resources, processed and otherwise, account for 85 percent of total exports, Chile remains vulnerable to possible changes in the global *physical* environment, whether it is the not-yet-fully-understood but increasingly potentially perturbing effects of global warming, a marked acceleration in the pace of worldwide biodiversity loss, depletion of fisheries and forests, and/or a large array of other global environmental problems, which are putting growing strains on the ability of the planet to sustain current levels of consumption. True, Chile in the past has benefited from its relative geographical isolation, which has protected it from pests and other environmental calamities, but those days are probably gone forever, and the country would no doubt benefit from greater diversification, Finnish style. The alternative is to remain unduly exposed to processes largely outside the control of Chilean society, as is the case with global warming and its consequences.



### The external environment

Clearly, one source of risk in the period ahead stems from various forms of instability in the region. The two instances in recent years when the Central Bank of Chile has had to intervene in the foreign exchange market—in order to respond to strong depreciating pressures on the peso—were both linked to instability in neighboring countries: Argentina in 2001, and Brazil in 2002. Trade and financial linkages between Chile and its neighbors are not insignificant. More generally, capital markets are capricious and prone to herding behavior, and so, even reasonably well managed economies are not immune to the risks of contagion. True, the countries that have been the first to be hit in recent episodes of contagion—e.g. Mexico in 1994–1995, the Asian economies in 1997–1998, and Russia and Brazil in 1998–1999—have typically suffered from one or more of the following: overvalued exchange rates, large current account deficits, high shares of short term debt, low ratios of liquid assets to liquid liabilities. None of these is a problem in Chile at present.

Contagion reflects a number of factors: changes in key economic parameters, such as world interest rates or commodity prices, or key exchange rates, all of which are beyond the control of developing country authorities. Trade spillovers, such as devaluation in Brazil and its consequent impact on Argentinian exports, or financial linkages, such as the exposure of Japanese banks to Thai corporations during the Asian crisis, have also been a factor. Changes in investor sentiment have also played a role. The globalization of capital markets and the constant search by the markets for "higher yield" means that countries like Chile will simply have to learn to cope with increased volatility and uncertainty.[22]

Crisis prevention in Chile, however, will remain very much the responsibility of the authorities. Central banks and the IMF could also play a role in preventing and/or containing financial crisis, and the spread of contagion. However, because the international financial system does not yet have—nor is it likely to have soon—an institution that can lend to solvent but illiquid borrowers, when no one else is prepared to do so, and in volumes sufficiently large to end financial panic, the burden of prevention and, in a crisis, action, will remain with the country's authorities. Chile's sound macroeconomic policies, combined with a major broadening of its trade and financial links with countries outside of the Latin American region—a full 75 percent of Chilean exports now go to the EU, the US, Canada and Asia—have greatly strengthened the resilience of the economy in times of crisis. But precisely because Chile has no control over its external economic environment, policymakers will have to remain ever vigilant. This will have to be especially so vis-à-vis the Latin American region, where Chile will have to steer a cautious middle course between expansion—very desirable in some areas, such as specialized banking services, and enhancing its role as a platform for transnational corporations wanting to do business elsewhere in the region—and undue exposure to countries that remain mired in unresolved and, in many cases, pernicious economic problems and political and social conflicts, which cast a shadow over their respective futures. The importance of geographical location, even in a fully globalized economy, is unlikely to fade away completely in the next decade; the Chilean economy will remain exposed to its troubled milieu.

## Concluding remarks

The World Economic Forum has sought to highlight the Chilean experience in this year's edition of *The Global Competitiveness Report*, because we feel that it has many features which are of considerable interest to its audience—the international business community, policymakers, the media and organizations of civil society. The country has managed to grow faster than many other countries in the developing world, boosting per capita incomes, and making further progress to reduce poverty levels. It has done so against the background of fiscal discipline and rapidly declining public debt levels, while maintaining an admirably open trade and foreign investment regime, and improving to a remarkable degree the quality of its public institutions, which have played a stabilizing and pivotal role in the country's recent evolution. By a wide margin, Chile is the most competitive economy in Latin America, and has the lowest levels of corruption in the developing world.

This chapter has identified a number of areas where challenges remain, however, if Chile is to successfully make the transition to the next stage of its development, a period when a combination of comparative advantages and the adoption of new technologies will facilitate the emergence of clusters, centered mainly on the natural resource sectors and the upstream development of supporting industries with higher value added. Critical to this process of development will be a substantial upgrading in the quality of Chile's educational system, which remains surprisingly inefficient, given the country's income levels. Without a major overhaul in this area, Chile risks finding itself with a labor force ill equipped to join the ranks of the most competitive economies of the world in the 21st century. This paper has also raised the question of whether the country—and in particular its political leadership—has reached the right balance, as regards the role of the state in the economy. There is no doubt whatsoever that the country has benefited from a system that has built in a number of safeguards to protect the public interest from the short-term interests of passing politicians and various forms of abuse—regrettably fully in evidence in much of the developing world. But this approach may need to make some limited room for a more active role for the state—as in Finland, for instance—with regard to the support for new ventures aimed at enhancing the country's potential for innovation. This is a delicate balance, but Chile could well benefit from a slightly less rigid interpretation of the wonders of the free market. While there are some sources of risk, both domestic and external, to our central scenario of continued growth and diversification, the way is wide open for the country to continue making gains in per capita income, and broadening the range of economic opportunities for all Chileans.

## Notes

1 The author would like to thank Andrés Allamand, Eduardo Bitrán, Edgardo Boeninger, José Joaquín Brunner, Hernán Büchi, Juan Claro Gonzáles, Marcel Claude, Vittorio Corbo, Nicolás Eyzaguirre, Daniel Fernández Koprich, Fernando Flores, Alejandro Foxley, Felipe Larraín Bascuñán, Guillermo LeFort, Patricio Meller, Cristian Morán, Joseph Ramos, Alvaro Saieh, Andrés Sanfuentes, Andrés Solimano, Hernán Somerville, Joaquín Vial, and Roberto Zahler, for their very useful comments and insights. Given the largely positive tone of the assessment made in this chapter, and for the benefit of the World Economic Forum's international readership, the author feels it appropriate to note that he is not a Chilean national.

2 As a purely indicative exercise we have projected GDP per capita in Argentina, Brazil, Chile and Mexico through 2010, assuming average GDP growth rates corresponding to 1994–2004, which includes a period of relatively *slow* growth in Chile. Chile's per capita income, which is already higher than that of Brazil and Mexico, will have overtaken Argentina by 2007.

3 These results are fairly robust with respect to the index chosen. For instance, the much richer index published elsewhere in this volume (see Chapter 1.3 by Sala-i-Martin and Artadi) shows a 20-place gap between Chile and Brazil, the country with the second highest ranking in Latin America.

4 The results of the election in India earlier this year are widely believed to have reflected widespread dissatisfaction with lack of sufficient progress in reducing poverty and improving income distribution, against the backdrop of rising expectations on the part of the Indian population. For a fuller discussion see Mishra (2004).

5 Since 1993 Argentina, Russia and Turkey have had a total of 20 governments: seven in Russia (Chernomyrdin, Kiriyenko, Primakov, Stepashin, Putin, Kasyanov and Fradkov); six in Turkey (Ciller, Yilmaz, Erbakan, Yilmaz (again), Ecevit, and Erdogan); and seven in Argentina (Menem, de la Rúa, Puerta, Camaño, Rodriguez Saá, Duhalde and Kirchner).

6 Richard N. Cooper, 1988.

7 A simple anecdote, for purposes of illustration: at a seminar in Moscow in October of 2003, the director of the World Economic Forum's Global Competitiveness Programme commented, to a distinguished audience of some of Russia's top business executives and officials, that inflation in Russia remained a concern. Many in the audience where puzzled, noting that, at 16 percent, Russian inflation in 2002 had been among the best in the country's (arguably short) history. They were surprised when told that international inflation in 2002 had been the lowest during the post-war period, that prices were decelerating everywhere, and that 16 percent put Russia in 93rd place among the 102 countries covered in the Forum's *Growth Competitiveness Index*.

8 See, for instance, Lopez-Claros (2003).

9 According to the IMF (2004) the agreement with the EU was "the most advanced trade deal the EU has ever negotiated with a non-member country." Under the terms of the agreement, 85 percent of Chilean exports to the EU now enjoy zero tariff, with the share rising to 96 percent by 2007, and to 99.7 percent by 2013.

10 We deliberately stay away from the debate in the literature about the "curse" of natural resources, on the grounds that Chile's stable institutional framework voids the traditional political economy arguments—valid mainly in countries run by corrupt elites—about rent-seeking in government-controlled natural resource industries.

11 Sen (1999) provides an excellent overview of some of the key issues. For a compelling list of real life examples see Easterly (2001), particularly Chapter 12, entitled Corruption and Growth.

12 Perhaps the most egregious example is Russian style privatization during the mid-1990s, the repercussions of which are still felt today, including in the international oil markets.

13 According to a recent EU study, the University of Chile is one of seven Latin American universities listed among the 500 best in the world. The Faculty of Economics of the University of Chile is able to place from 20 to 25 of its economics graduates in the top 20 Ph.D. programs in the United States.

14 A full description of the five categories used for assessing reading literacy may be found at: http://www.pisa.oecd.org/Docs/download/pisaplus_eng01.pdf. For instance, in the area of "interpreting texts", level 5 involves "either construing the meaning of nuanced language or demonstrating a full and detailed understanding of a text."

15 Having said this, we are of the view that there is no credible alternative in Chile in the short term to inflation targeting, even though, in an uncertain environment, the Central Bank of Chile—as all other central banks similarly engaged—is bound to err occasionally.

16 The phase of privatization of the mid 1980s was accompanied by strong incentives for investment, including debt/equity swaps and, for a while, preferential exchange rates for investment. These are clearly no longer replicable, and cannot be expected to play the role of engines of growth.

17 English is by now far more widely spoken in Estonia, the Czech Republic, Hungary and other countries in eastern and central Europe than in Chile. We are certain this was not the case in the late 1980s,

when these countries were all Soviet satellites. For some compelling statistics, see The Economist, 2004.

18 Or, for that matter, those unions representing the medical profession; health expenditure in Chile is also very inefficient.

19 Foxley (2003) notes that in Chile "the maximum share of matching grants for innovative projects is 6 percent, whereas in Finland the public sector contribution may reach 50 percent, even 70 percent of the resources needed to introduce the innovation of the startup."

20 To cast further light on this debate, see the interesting case study put together at the Harvard Business School (2003), entitled "Building a Cluster: Electronics and Information Technology in Costa Rica," which provides a fascinating perspective on how Costa Rica was able to edge out Chile in the competition to persuade Intel to establish its next Assembly and Testing Plant (ATP) for microprocessors in San José. In a nut shell, it was done through the active personal involvement of the head of state, who met all 15 Intel missions which visited the country during the period April to November 1996.

21 The World Bank's international poverty line shows that in 2000 in Latin America, Costa Rica and Chile had the second and third lowest shares of the population living on less than US$2 per day—9.5 percent and 9.6 percent respectively, compared to 14.3 percent in Argentina, 26.3 percent in Brazil, 22.6 percent in Colombia, 22.4 percent in Mexico, and 32 percent in Venezuela. Only Uruguay, at 3.9 percent, had significantly better numbers.

22 In any case, some of the surge in capital inflows in the 1990s clearly reflected some good things: improvements in macroeconomic management in many emerging markets, opening of capital accounts, trade liberalization, a more open attitude toward privatization, a wider choice of assets for investors in domestic markets, improvements in credit ratings, all of which have been characteristic of Chile.

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