Managing the Crisis |

Chile Country Report

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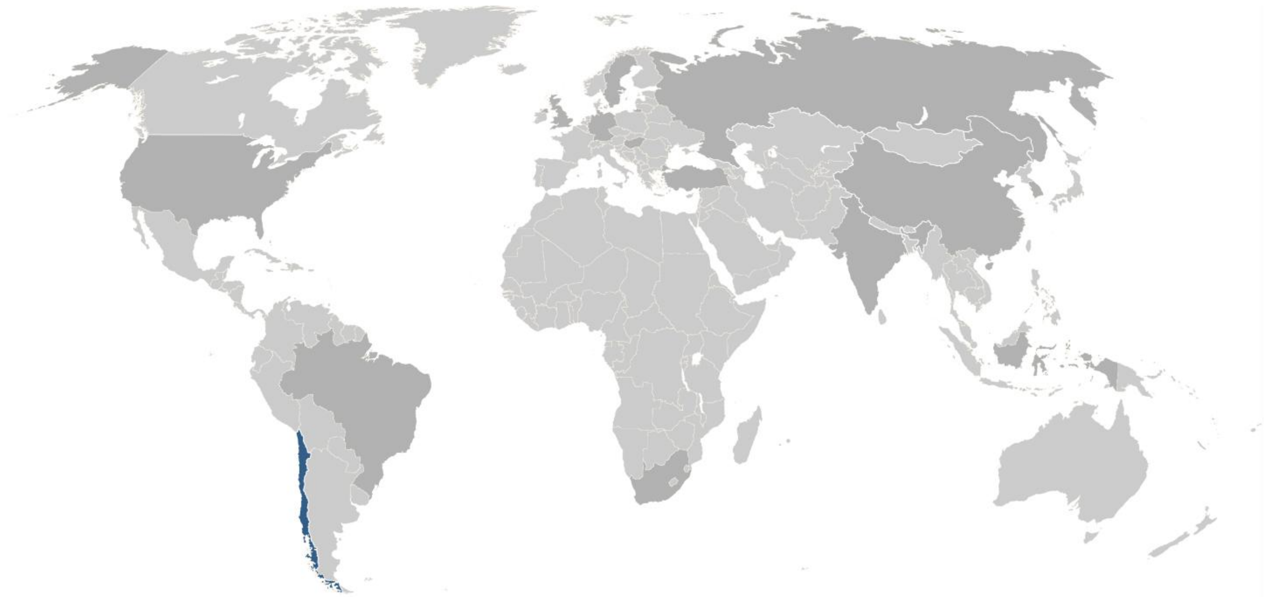

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According to the IMF, Chile was among the Latin American countries most affected by the international financial crisis.[1] Chile's GDP is expected to contract by 1.7 percent during 2009, while forecasts for regional peers Brazil, Peru, Colombia and Uruguay are respectively -0.7 percent, +1.5 percent, -0.3 percent and +0.6 percent.

The impact of the international economic crisis was rapid and deep, partly because Chile's high trade and capital market integration. However, the country implemented a series of fiscal and monetary policies that helped counteract the adverse effects of the external economic downturn. More importantly, the country benefited from an outstanding macroeconomic situation as well as an extremely sound domestic financial market. The latter means the country is well-poised for recovery during 2010. Indeed, the IMF predicts that Chile will lead growth within the region in 2010. In this document we survey the economic conditions of Chile prior to the crisis, the impact of the crisis itself and the policy response from the country's economic authorities.

1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

In 2007, Chile's gross investment represented 29.7 percent of GDP.[2] Private and government consumption respectively reached 68.2 percent and 12.8 percent of GDP, while exports and imports respectively accounted for 39.8 percent and 51 percent of GDP.

On a yearly basis, gross investment grew by 29.9 percent during the third quarter of 2008 (the last data available). During the same period, imports rose by 20.3 percent. Both figures were higher than the increases observed during the third quarter of 2007 (12% and 14.9% respectively).

In 2007, the trade balance was $23.6 billion, and the current account registered a surplus of $7.2 billion (4.4% of GDP).[3] The net external debt

[1]IMF, World Economic Outlook, October 2009. 85: http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/text.pdf, (accessed November 2, 2009).
[2]Central Bank of Chile, Informes de Política Monetaria , May 2009; http://www.bcentral.cl/publicaciones/politicas/pdf/ipm092009.pdf (accessed November 2, 2010).
[3]Throughout this paper, the $ sign will refer to U.S. dollar amounts. Chilean peso amounts will be explicitly identified as such.

exhibited a creditor balance of $13.6 billion (8.3% of GDP),[4] while the government balance was $16.3 billion (10% of GDP).[5]

In the last several decades, the Chilean financial system has developed remarkably. Financial assets rose from 50 percent of GDP during the 1980s to nearly 200 percent of GDP in 2008. Banks are the major source of corporate external financing (3.3% of the total in December 2008). During the last year, banking credit has been somewhat constrained because of the crisis, thus resulting in a move toward arms-length markets.[6]

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities prior to crisis

The current government took office in March 2006, for a four-year period. By 2008, economic growth reached an average of 4.5 percent per annum. This contributed to a reduction in the high unemployment rate inherited from the previous administration, from 9.7 percent to 7.5 percent.

Inflation was one of the major macroeconomic concerns during 2008. From an average rate of 2.6 percent in 2006, inflation rose to 7.8 percent in 2008 and reached a peak of 9.9 percent in October 2008 (on an annual basis). The increase in international oil prices, some food product costs and electricity rates accounted for nearly 1.5 percent of the inflation rate.

At the public sector level, Chile has followed a structural fiscal rule since 2001. Until 2007, the rule set an explicit structural surplus target of one percent of GDP. In 2008, the target was reduced to a surplus of 0.5 percent of GDP, and during 2009 it was changed to a structural budget balance (0% of GDP). The rule is a countercyclical scheme benefiting from transversal political support in the country. As a result of the rule and the very high copper prices during the last several years, the government experienced significant current budget surpluses of 8.8 percent of GDP in 2007 and 5.3 percent in 2008.[7]

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[4] Liabilities of $55.9 billion and assets of $69.5 billion.

[5] GDP figures are from 2007.

[6] Central Bank of Chile, *Informe de Estabilidad Financiera*, first half of 2009, 36; http://www.bcentral.cl/publicaciones/politicas/pdf/ief2009_1.pdf. (accessed November 02, 2009).

[7] The rule is based on a projection of state structural revenues, which have two primary sources: taxes and the revenues from the state-owned copper company CODELCO. Given the latter source, two relevant parameters must be estimated in order to estimate the government's structural revenues. These include the long-term economic growth rate (which affects tax collection) and the long-term price of copper. These estimates are made every year by a panel of local independent consultants; Dirección de Presupuestos (DIPRES), *Acta Resultados del Comité Consultivo del PIB Tendencial*, 2007-2009: www.dipres.cl, www.dipres.cl (accessed November 2, 2009).

Up to the end of 2008, the central bank's main macroeconomic concern was inflation. As a result, its monetary policy was restrictive in order to reach its explicit inflation target of around three percent.[8] At the same time, the government undertook a series of bonus packages aimed at mitigating the poorest households' difficulties with price increases, particularly of oil and electricity.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

During its first years in office, the government faced several credibility problems and waves of popular discontent. In 2006, the government experienced a massive student strike (called the "penguin revolt"), called to protest the quality of the Chilean educational system. Public discontent rose in 2007 due to the massive failure of a new public transport project implemented in Santiago (the so-called Transantiago).[9] These events took place against the background of unusual cabinet turnover in some ministries.[10] As a result, by June 2008, the popularity of the government had fallen. According to a survey conducted by the Centro de Estudios Públicos (CEP) at this time, the government's approval rating (39%) had fallen below its disapproval rating (44%) for the first time since taking office in 2006.[11]

In Chile, macroeconomic and financial policies are extremely sound. According to the last World Economic Forum (WEF) Global Competitiveness Report, Chile ranked 19th out of 133 countries in terms of its macroeconomic policies, a position consistent with its record since 2001. The main features of the macroeconomic policies are a floating exchange rate, inflation targeting by an independent central bank and the existence of a credible structural fiscal rule.[12] Since the banking crisis of 1982, which seriously affected the economy and the domestic banking sector, the financial sector has been ruled by effective prudential supervision. The combination of outstanding macroeconomic fundamentals and a solid financial sector allowed the country to confront the current financial crisis in very good shape.

[8] Central Bank of Chile, "La Política Monetaria del Banco Central de Chile en el Marco de Metas de Inflación," (2007): www.bcentral.cl (accessed November 2, 2010).

[9] Santiago accounts for nearly 40% of the country's total population.

[10] For example, between March 2006 and September 2008, there were four different education ministers.

[11] Centro de Estudios Públicos (CEP) is a private think tank. Its opinion survey is Chile's most prestigious. See www.cepchile.cl/dms/lang_1/doc_4453.html (accessed November 2, 2010).

[12] For more details on central bank policy, see Central Bank of Chile, "La Política Monetaria del Banco Central de Chile en el Marco de Metas de Inflación", 2007; For more details on Chilean fiscal policy, see J. Rodríguez, J. Tokman and A. Vega, "Structural Balance Policy in Chile", *OECD Journal on Budgeting*, 7 no.2 (2007).

The fiscal rule has provided the government with a credible spending commitment. More importantly, because the rule is countercyclical, the government saved over $42 billion (22.6% of GDP) between 2004 and 2008, when copper prices were high. When the crisis started near the end of 2008, the Chilean government had more than $20 billion (10.8% of GDP) invested in two sovereign funds. In turn, these exhibited good financial performance even during 2009 (as opposed to sovereign funds in other countries).[13] These funds gave the government the flexibility to undertake an expansionist fiscal policy during 2009, thus reducing the negative domestic impact of the crisis. The country's solid macroeconomic fundamentals have also allowed the government to retain access to international capital markets at relatively favorable terms.[14]

The crisis also provided room to the monetary authority to undertake an aggressive monetary policy, with high reductions in the interest rate from a maximum of 8.25 percent in October 2008 to 0.5 percent at the time of writing. In addition, between April and September 2008, the central bank bought nearly $6 billion (3.2% of GDP) in reserves. This improved the central bank's already solid reserve position and left the monetary authority in a comfortable position to accommodate further external shocks in the case of a worsening of the external situation.[15]

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Exposure to specific market and trade risks

Chile is a very open country, both in terms of commercial and financial flows. This naturally exposes the country to situations of external economic distress. The process of opening started three decades ago and increased after the return of democracy in the 1990s, including several free trade agreements and the relaxation of capital-flow restrictions. In addition, Chile has had a free exchange rate since 1999, with only a few sporadic interventions by the central bank.

13 Finance Ministry, *Informe anual Fondos Soberanos* http://www.hacienda..cl/fondos/doc/informe_anual_fondos_soberanos_2008.pdf (accessed November 2, 2009).

14 GDP figures are calculated as a proportion of expected 2009 GDP ($144 billion)

15 Initially, the Central Bank of Chile announced that it will buy 8 billion dollars. However, at the end, purchases totaled only 5.75 billion. Central Bank of Chile, Press Report, April 2008 http://www.bcentral.cl/prensa/comunicados-consejo/otros-temas/10042008.pdf; Central Bank of Chile, Press Report September 2008 http://www.bcentral.cl/prensa/comunicados-consejo/otros-temas/29092008.pdf (accessed November 2, 2009)

This strategy of openness has received considerable political support both from the center-left ruling coalition and the center-right opposition. This is why there is no appreciable risk of protectionism. Even during the crisis, nobody has proposed policies tending in this direction. Indeed, trade openness is one of the pillars of the Chilean economy. Chile has an average tariff rate of only 3 percent. The country has signed free trade agreements with NAFTA (2004), the EEU (2003), Japan (2007), China (2005), Korea (2004) and Australia (2008).

In 2008, imports represented about 38 percent of GDP. Imports are led by consumer and capital goods, oil, and other energy sources (primarily gas). Because of the high prices of oil during recent years, the government has launched an agenda seeking to diversify the country's energy matrix.

Exports accounted for 44 percent of GDP in 2008. During the last decade, mining accounted for 52 percent of total exports (copper alone represented 46% of total exports). Industrial exports represented 40 percent of the total. Cellulose and paper, salmon, and fruits lead non-copper exports. Due to the high copper prices experienced since 2005, the relative importance of mining exports has increased in recent years, reaching an average of 63 percent between 2005 and 2008.

While exports are still highly concentrated in the mining sector, this proportion has significantly diminished over the course of the last three decades, thus showing some signs of diversification: mining represented 60 percent of the total during the 1980s, 46 percent during the 1990s and 47 percent from 2000 to 2004. Interestingly, during the last several years the government has made efforts to develop global services (offshoring) as a new source of exports. In 2009, global service exports (mainly associated with the financial sector) are expected to reach $1 billion (2% of total exports). This global services focus resulted from an Innovation Council appointed in 2004, which is in charge of identifying and supporting new export clusters based on innovation and increasing the proportion of domestically added value. Financial resources for developing this strategy come from a new mining tax (the "royalty") introduced in 2005. During 2007 and 2008 this tax has collected nearly $1.2 billion (0.5% of GDP each year).

The well-developed financial sector has been a crucial element in Chile's economic growth. The size of the domestic financial market is around 200 percent of GDP. It is characterized by sound risk evaluation processes and prudential supervision. Indeed, the soundness of the Chilean financial system can be identified as one of the country's major current assets, and certainly contributed to the country's ability to weather the liquidity restrictions produced by the current international crisis. Neither real estate bubbles (even when the central bank relaxed its monetary policy) nor banking problems such as those in the United States occurred in Chile.

The banking system operates in a relatively competitive environment, with more than 30 banks. In addition, the retail industry plays a dynamic role in providing consumer credit, while the insurance companies are very active in real estate financing. In September 2008, the banking sector's health was outstanding. According to the IMF, the ratio of non-performing loans to total loans reached 1.2 percent in May 2009.[16] This figure is similar to the one registered in 2004 but somewhat higher than 2008's average (1%). However, the ratio is low by international standards, falling below the figure in most developed countries and largely below the average of other emerging economies. According to the WEF Global Competitiveness Report 2009 – 2010, the Chilean banking industry ranked 4th (out of 133 countries) in terms of soundness.[17] In August 2008, the ratio of capital to assets (risk weighted) was about 12 percent, a figure in line with the observed historical trend.[18] The liquidity of the financial system was stable and backed by liquid assets: In August 2008, cash and short-term liquid assets accounted for 13.5 percent of total liabilities.

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

One important difference between the current crisis and the Asian crisis of 1997 has been the level of coordination between local fiscal and monetary authorities. Several analysts claim that during the Asian crisis, the central bank helped make the situation worse by restricting credit. For its part, the government at that time minimized the external shock and did not pursue an active fiscal policy. A lesson was learned from that situation's outcome. This time, monetary and fiscal authorities both reacted promptly and in a coordinated fashion. The central bank aggressively reduced its interest rate, from 8.25 percent in January 2009 to 0.5 percent in July of the same year, while the government implemented a large fiscal stimulus package.

[16] IMF, *Global Financial Stability Report*, October 2009: 219, http://imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf (accessed November 2, 2009).
[17] World Bank, *The Global Competitiveness Report 2009-2010*, 115, http://www.weforum.org/documents/GCR09/index.htlm, (accessed November 2, 2009).
[18] Superintendencia de Bancos e Instituciones Financieras Chile (SBIF), *Panorama de la Industria Bancaria Septiembre de 2008*, 2, http://www.sbif.cl/sbifweb/servlet/InfoFinanciera?indice=4.1&idCategoria=565&tipocont=0 (accessed November 2, 2009).

The Chilean financial market is governed by high-skilled agencies and appropriate prudential rules. Banking supervision is under the charge of the Superintendencia de Bancos e Instituciones Financieras (SBIF), a public autonomous institution. The Superintendencia de Valores y Seguros (SVS) is the main regulatory body for the domestic financial market, supervising all activities and entities participating in the Chilean securities and insurance markets. It enforces compliance with all laws and regulations governing the financial market, and has the power to impose sanctions. On the demand side, the pension funds represent the country's major institutional investors. Their combined financial assets (totaling 90% of the country's GDP) account for half the stock of financial liabilities of the Chilean economy. Pension funds investments are ruled by risk criteria and are supervised by a third regulatory body, the Superintendencia de Pensiones.

Although Chile has a strong presidential system, the government lacks the discretionary powers to spend during a crisis. In Chile, the budget is approved by the National Congress once a year. Any special financial package requires a law that must also be submitted to National Congress. The government has only limited ability to reassign funds already approved in the budget.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

Because of its high level of trade and financial exposure, the economy was severely affected by the crisis. Export volume dropped by nearly 20 percent, and the official growth estimates for 2009 range from -1.5 percent to -2 percent.[19] As soon as November 2008, economic activity exhibited negative year-to-year numbers as measured by the Monthly Index of Economic Activity (Índice Mensual de Actividad Económica, IMACEC).[20] The most dramatic fall occurred in April 2009, when activity declined by 5.1 percent. Industrial production fell by 9.3 percent during the first half of 2009. As a result, the unemployment rate grew from 7.5 percent in 2008 to 10.8 percent during the second quarter of 2009.

[19] Finance Ministry, "Crisis: Rol de las políticas Contracíclicas y lecciones para el futuro," http://www.hacienda.cl/documentos/presentaciones.php,(accessed November 2, 2009).
[20] Central Bank of Chile, *Índice Mensual de Actividad Económica (Monthly Economic Activity Index)*, http://si2.bcentral.cl/Basededatoseconomicos/951_417.asp?LlamadaPortada=SI (accessed November 2, 2009).

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

The policy response both from fiscal and monetary authorities was fast and coordinated. During 2009, the central bank reduced the interest rate by 775 basis points. This complemented several other measures whose goal was to provide liquidity to the market (see also "monetary and currency policies"). For its part, the government announced its first actions aimed at countering the crisis as soon as October 2008. Among them were policies intended to support small exporters and companies, small mining firms, and middle-income families purchasing housing. The major announcement occurred on January 5th, when the government launched a fiscal stimulus package of $4 billion (2.8% of GDP, and 14% of planned current fiscal expenditure). The plan was then complemented by a national agreement on labor market assistance, job protection and job-training stimulus, which was unanimously approved by the National Congress in May 2009.

The government also launched a plan called Pro Crédito. The plan aimed to spur the availability of bank credit, especially for small and medium-sized enterprises (SMEs), and to increase competition in the banking industry in order to ensure a faster and more efficient implementation of the interest rate cuts decreed by the central bank.[21] The plan was also unanimously approved by National Congress during April 2009.[22]

The fiscal stimulus plan required approval by the legislature. One salient feature within the Chilean policy-making process is that the plan benefited from rapid national consensus. As soon as January 20th, the plan announced just 15 days before was legally and unanimously approved by the National Congress in the form of Law 20, 236. Finance Minister Andrés Velasco ac-

[21] SMEs, or pequeña y mediana empresas (PYMES), account for nearly 80% of total employment.

[22] Seven out of the 20 measures contained in the Pro Crédito Plan required legal amendments. The remaining 13 items corresponded to administrative reassignments and management policies. For details, see Finance Ministry, Iniciativa Pro Crédito," "http://www.minhda.cl/documentos/detalle.php?id=13259&code=clT9ds73CexAY# (accessed November 2, 2009).

knowledged the support received from a number of economic analysts, but especially those from the political class.[23]

During 2008, the national workers union (Central Unitaria de Trabajadores de Chile, CUT) requested a series of measures, including the establishment of a fiscal subvention for hiring, as well as improvements in the existing mechanism for unemployment insurance. This claim was in line with one of the recommendations released in May 2008 by a presidential commission for employment and equality (the commission was established by the president in August 2007).[24] On December 15, 2008 the government and the CUT reached an agreement regarding the insurance scheme, and on January 24, 2009, they signed an agreement on subventions. Both provisions were included in a law finally enacted by the National Congress on March 25, 2009 (Law 20, 338).

In addition to the CUT requests, exporters sought a competitive depreciation of the Chilean peso. However, neither the central bank nor the government took explicit measures in this direction. As in other countries, the real estate construction industry was one of the most affected by the crisis. The industry was unsuccessful in lobbying the government for tax exemptions. However, through the state-owned Banco Estado, the major companies reached an agreement to offer highly discounted mortgage rates for housing financing. The relaxation in monetary policy also assisted the sector.

Aside from the aforementioned cases, there is no explicit evidence of lobbying taking place, at least in terms of determining the provisions of the fiscal stimulus plan as implemented.

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

The country did not explicitly rely on international economic advisors. Instead, local advisors assisted the Finance Ministry in the international investment of fiscal savings. Finance Minister Velasco is a scholar of high reputation, and a specialist in financial crises. Before taking office he was a professor of economics at Harvard University. As a result, Velasco has a

[23] The stimulus plan was announced on January 5th. Two days later, the Finance Committee of the Chamber of Deputies unanimously approved the proposal, which was then ratified by the National Congress on January 8th, also unanimously.

[24] For details, see www.trabajoyequidad.cl/view/informe.asp (accessed November 2, 2009). The “Consejo de trabajo y equidad” was a special commission launched by president Michele Bachelet in August 2007 to analyze the client labor market and the country’s income distribution.

network of academic scholars he informally consults that includes Nouriel Roubini, Larry Summers, Henry Paulson and Guillermo Calvo.[25]

For their part, staffers from the Finance Ministry and the central bank's board of directors actively attend international seminars where they can share views with international experts. The list includes the Mercosur Summit in October 2008 and a Comisión Económica para América Latina y el Caribe (CEPAL) meeting in July 2009, to which representatives from the IMF, the Inter-American Development Bank (IADB) and the World Bank were invited. In April 2009, during the G-20 meeting, President Michelle Bachelet made a presentation on coordination, international response and domestic policies, especially for countries having fiscal savings.[26] In June 2009, at the CEPAL headquarters in Santiago, the finance ministry advisors of several Latin American countries met to discuss an agenda and to set policy recommendations for a new financial architecture.

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

As previously mentioned, fiscal policy was at the core of the Chilean government response to the crisis. This included a nominal stimulus package of 2.8 percent of GDP during 2009. However, the resources effectively allocated are expected to represent just 1.9 percent of GDP. The measures included in the plan have a one-year term. The next government, depending on the future situation, must decide if these policy actions should be extended.[27]

Part of the plan was financed through the liquidation in the domestic market of $3 billion the government had invested abroad.

[25] Revista Qué Pasa, January 17, 2009.
[26] Michelle Bachelet, "An immediate, potent and coordinated response to the world economic crisis: The view from Chile and Latin America," http://minhda.cl/prensa/documentos_de_interes.php?id=&page=2&code=clviGvjGV2xgc# (accessed November 2, 2009).
[27] Presidential and parliamentary elections will be held in December 2009.

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Targeting and coverage of policy tools

The fiscal plan has a mixture of new fiscal spending, mainly targeted at low-income households ($1.1 billion), investment ($1.7 billion) and tax cuts, including specific tax cuts in the credit market, the advancement of planned tax credits and a temporary reduction in provisional monthly tax prepayments for companies ($1.1 billion).

The plan was based on four pillars:

- Incentives for spending and investment (I&S)
- Expanding credit access for companies (A&C)
- Support to (largely low-income) people (S&P)
- Employment protection and incentives for workers' training (L&T)

Table 1 summarizes the relative importance of each of these categories as well as the expected resources effectively allocated during 2009.[28] Every measure included in the plan has a solid justification, including explicit objectives and their associated costs.

Table 1: Chilean government stimulus activities in response to financial crisis

Pillar	Item	Cost (million $)	%	Effectively implemented (million $)
I&S	Capitalization of Codelco (*)	1000	24.7	0
I&S	Public investment	700	17.3	500
I&S	Stamp tax elimination	628	15.5	628
A&C	Transitory reduction of PMP	460	11.4	460
S&P	Public transport subvention	400	9.9	350
S&P	Bond ($75) to low income households	224	5.5	224

[28] For details, see Finance Ministry, "Plan Fiscal 2009," www.hacienda.gov.cl/prensa/doc/plan_fiscal/detalle_medidas_plan_fiscal.pdf (accessed November 2, 2009).

Pillar	Item	Cost (million $)	%	Effectively implemented (million $)
S&P	Anticipated devolution of tax-payers credits	220	5.4	220
L&T	Training subventions	147	3.6	130
L&T	Work subvention	102	2.5	102
A&C	Credit lines to CORFO for factoring	50	1.2	50
A&C	Credit line to Corfo for companies credit reprogramming	50	1.2	50
I&S	Subventions to municipal funds	41	1.0	35
I&S	Forest incentives	20	0.5	10
	Total (million $)	4042		2759
	Total (% GDP)	2.8		1.9

Source: Plan de Estimulo Fiscal. www.hacienda.gov.cl. (*) Since this item corresponds to a capitalization of the SOE Codelco, we assume it does not have any macroeconomic impact.

Later, in May 2009, the government launched supplementary fiscal policies including cash stipends of about $70 (CLP 40,000) for poor families that benefited more than 4 million people. Aside, the government introduced insurance mechanisms for higher education financing and mortgage dividends.

There are no related specific measures aimed at support of the financial or banking system. As described above, the financial system entered the crisis in a solid position. Thus, there was no need to provide special liquidity lines or to bail out financial institutions. Instead, the government injected $500 million in fresh capital into the state bank BancoEstado. These funds were intended to be used to provide credit to small and medium-sized companies. A similar goal was pursued in expanding some credit lines of the Chilean Economic Development Agency (CORFO), a public agency whose goal is to promote new business (see Table 1).

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

Development as an objective of stimulus policies

Fiscal policy in Chile has a one-year horizon. The fiscal stimulus plan fits into this timing. It is composed of temporary (short-term) measures explicitly designed to face the current crisis by giving support to low-income households and small and medium-sized companies. As a result, the plan is consonant with the development strategy pursued by the country before the crisis.

Some of the complementary measures announced, such as the employment and training agreement, could enhance labor market structural reforms, specifically in terms of enhancing the flexibility of workers to switch between industrial sectors, as recommended by the IMF.

In the same fashion, the Pro Crédito policies (March 2009) that complemented the countercyclical fiscal plan of January 2009 could foster long-term policies in the capital market, both in terms of making credit access easier and contributing to transform the country into an exporter of financial services in the long run.

In summary, the majority of the current economic measures correspond to temporary countercyclical policies intended to address the adverse effects of the international crisis.

- Has the stimulus included “buy national” clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country’s executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

National bias and protectionism

Chile has a solid record of openness both in terms of the trade and capital accounts. There are no significant forces lobbying for protectionism. Indeed, during the G-20 summit, President Bachelet declared Chile’s complete opposition to any international protectionist measures designed to face the crisis, including classical trade tariffs as well as financial barriers. She called for a political agreement eschewing protectionism, arguing that free trade was not part of the problem, but was rather a solution that would help foster economic recuperation. Protectionism, she claimed, would aggravate the situation.

Measures implemented to support the export sector include a new rule allowing taxes to be paid in international currency over the Internet, and an acceleration of the devolution of VAT credits to exporters. In addition, the government continued to invest the majority of its surplus abroad in order to avoid an appreciation of the local currency. Along the same line, it raised the cap on the amount that pension funds could invest abroad.

On April 10, 2008, the central bank announced the purchase of $8 billion at a pace of $50 million per day until December 12, 2008. While the main argument for such a measure was the necessity of improving the bank's reserve position in case of a weakening of the external financial situation, the intervention coincided with a period of strong appreciation of the Chilean peso. On September 29th, the bank declared an end to its purchases. All in all, the bank was able to increase its reserves by $5.75 billion. At the same time, following the beginning of the exchange rate intervention, the Chilean peso depreciated by 25 percent in nominal terms.

It is worth noting that the majority of the government's fiscal stimulus was financed by the liquidation in the local market of $3 billion invested abroad (the central bank acted as intermediary for these operations), thus introducing appreciatory pressure on the local currency.

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Social protection

Increasing social protection has been a key goal of the Bachelet administration. The main measures adopted during the current crisis also tended in this direction.

More than 100,000 jobs were created by the investment plan contained in the fiscal stimulus package. In addition, the government implemented subventions for low-income young unskilled workers, a group in which the unemployment rate is three times higher than the national average, and promoted an extension of unemployment insurance for workers with temporary work contracts.[29]

[29] The law benefits workers between 18 and 25 years old belonging to the poorest 40% of the population. See Law 20, 338 for details.

A law enacted on May 28th, 2009 (Law 20,351) provided tax reductions to companies retaining workers. In addition, it offered incentives for worker training, by granting workers a special authorization to undertake training outside their own firms. While the firm pays no salary during the employee's training, the worker remains affiliated to her company and keeps her social benefits. The worker receives 50 percent of her salary from unemployment insurance. The law was the result of the tripartite (including government, workers' unions and companies) national agreement for employment, training and labor protection.

As previously mentioned, government policies also included direct subventions to low- income households. The first was distributed in March 2009 to 1.7 million households, in the amount of $70 (CLP 40,000). A second stipend for a similar amount was paid in July, this time benefiting more than 4 million people.

A third measure advanced to 2009 the benefits of a pension reform originally announced for 2010. This benefited 950,000 retired people by increasing the amount of their basic retirement pensions.[30]

In addition, an insurance mechanism for tertiary education financing was put in place in 2009, in case of a parent's unemployment. A second insurance plan related to mortgage payments was also created, covering up to four monthly payments in case of unemployment.

As part of the January 2009 fiscal plan, the government also offered an early distribution of income tax credits. Instead of the regular process, in which eligible taxpayers would wait until April 2010 for their cash reimbursement, the procedure was allowed to start in September 2009. The amount of this refund could not exceed the amount of approximately $410 per taxpayer.

[30] For details, see Law 20, 366. http://www.bcn.cl/histley/lfs/hdl-20366/HL20366.pdf (accessed November 2, 2009).

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

The government has been extremely transparent in announcing its special measures and their detailed justification and cost. All relevant information, including press reports and documents detailing each proposal, is available through the Finance Ministry Web site. This transparency orientation has also been strengthened by the implementation of a national transparency law in June 2009. The law requires every public service to provide public information on their activities and data records. In September 2008, President Bachelet and her finance minister made a televised public speech presenting their budget proposal for the next year. The speech addressed the potential external economic problems and announced an expansionary budget for 2009. On January 5th, the government announced and detailed the implementation of a fiscal stimulus plan. Complementary measures were submitted during the annual presidential speech to the National Congress on May 21st.

The government policies benefited from significant support by analysts and citizens. During 2009, both the president and her finance minister attained historical levels of public support. According to the CEP's public opinion survey, President Bachelet's approval rating climbed to 72 percent in August 2009, from just 39 percent in June 2008. The survey also indicated that 55 percent of Chileans strongly supported the economic management of the country during 2009. Another opinion survey showed that the popularity of the Finance Ministry grew from 31 percent in June 2008 to 68 percent one year later.[31]

[31] Adimark, "Evaluación de la Gestión del Gobierno," www.adimark.cl/estudios/eggago09.act (accessed November 2, 2009).

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

The general perception is that the government reacted in a timely manner to the crisis. As previously mentioned, when presenting its budget in September 2008, the government internalized the signs of forthcoming economic problems. More importantly, as early as January 2009, the government presented a massive stimulus plan that was augmented in May 2009. This government reaction contrasts sharply with the relatively slow response during the Asian crisis.

All political parties, economic analysts and civil society groups largely supported the government measures. This is the main reason why the stimulus plan was approved quickly and unanimously in the National Congress. One example of the rapidity of the implementation was the case of the cash stipend to low-income households: Announced in January, its delivery occurred only two months later (March).

In general, the policies announced were temporary. They were aimed at granting social protection to poor families during the crisis, addressing temporary unemployment problems and easing credit access for small and medium-sized firms. The measures undertaken did not benefit specific interest groups. Instead, they tended to follow a common rule, benefiting economic activities instead of specific industries.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

There was no explicit strategy of implementing economic policies coordinated with other governments in the region. Instead, as mentioned, the government and the central bank were very active in participating in international seminars organized to discuss the crisis and share policy experiences.

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

The stimulus plan of $4 billion (2.8% of GDP) was based on a mixture of fiscal spending and temporary tax reductions. Tax measures were mainly focused on enhancing investment, providing incentives for employee retention and increasing consumption.

One of the measures was the provisional elimination during 2009 of a stamp tax of 1.2 percent affecting credit operations, including bills of exchange, bills, promissory notes, simple or documented credits, mortgages, and the prorogues or renewals of these documents or of loan transactions. The tax is particularly relevant for small and medium-sized companies, as well as for people seeking to buy a house using mortgage financing. The tax rate is slated grow to 0.6 percent in 2010. The estimated cost of the tax elimination for 2009 (in terms of lost fiscal revenues) was $628 million (0.4% of GDP). Along the same lines, in September 2008 the government passed a law permanently eliminating a specific tax on ATM withdrawals and check payments ($0.25 per transaction).

In addition, the government decreed a temporary reduction (until May 2010) in the provisional monthly prepayment (PMP) rate for year 2009. These monthly payments serve as a credit against the annual tax companies must pay on their profits. The measure implemented provided liquidity to firms, especially for small and medium-sized ones. The reduction was as follows: 15 percent for small and medium-sized companies with gross income below $3.3 million; and 7 percent in the case of companies with revenues exceeding this amount. The estimated cost of this temporary tax reduction was $460 million. In parallel, the government established a temporary tax deduction for companies investing in worker training. This deduction could be used as a credit against the PMP. Finally, in September 2008, the government also offered early distribution of income tax credits for taxpayers, up to an individual amount of roughly $410.

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/ stabilization

During most of 2008, the efforts of the Chilean central bank were focused on fighting inflation. Despite a yearly target of three percent, inflation reached an annual rate of 9.9 percent during October 2008. The central bank tightened its monetary policy, raising its interest rate from 5.75 percent in December 2007 to a peak of 8.25 percent in December 2008. The latter was possible since Chile has a floating exchange regime.

As the crisis became evident and growth projections for 2009 declined, inflation ceased being the major concern. On the one hand, low domestic aggregate demand as well as a decline in international oil prices provided pressure toward a decline in domestic prices. On the other, a relaxation in monetary policy was necessary to crowd out the external shock and provide the market with liquidity. As a result, beginning in January 2009 the central bank undertook a process of systematic reductions in its referential interest rate. In July, this rate reached a record level of just 0.5 percent. Thus, in facing the crisis, monetary policy was in line with the government's expansionist fiscal policy.

In July 2009, the central bank announced it would provide liquidity both in Chilean pesos and U.S. dollars through repos and swaps. This measure was effective in aligning the domestic interest rate with the monetary interest rate.[32]

Regarding the exchange rate market, in April 2008 the central bank launched a program of reserve increase by means of purchasing $50 million per day, up to a cumulative total amount of $8 billion. The program coincided with a period in which the Chilean peso experienced strong nominal appreciation, thus possibly affecting the export sector. As the economic external situation deteriorated, the bank decided to suspend the program in September. In sum, it bought nearly $6 billion (an increase in its reserves by 35%).

[32] Informe de Política Monetaria (IPOM) September 2009. Also see, Chile Frente a la Recesión Mundial del 2009," José De Gregorio. President of the Central Bank of Chile, Economic Policy Papers, March 2009.

Credibility of funding mechanisms

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

One of the salient features of fiscal policy in Chile is the existence of a structural budget rule. The rule was first implemented in 2001, setting a structural fiscal target surplus of one percent of GDP.[33] The rule is not written in law, but is grounded in an informal institutional agreement. The key point, however, is that the rule has a high degree of credibility. All political sectors and economic analysts support the rule. In 2007 (in plans for the 2008 budget), the target was reduced to a surplus of 0.5 percent of GDP. Then in January 2009, in conjunction with the stimulus plan, the government announced a structural balance target (0% of GDP).

The rule's basic implications are twofold. On the one hand, it provides a credible commitment of fiscal responsibility. The government has always respected the defined structural target. On the other hand, the rule means that fiscal policy in Chile is countercyclical, thus allowing an expansionist policy in recession years like 2009. As a result of the rule and of high copper prices, the government had significant current budget surpluses in 2006, 2007 and 2008 (7.7%, 8.8% and 4.8% of GDP, respectively). The majority of these savings was invested abroad. These government savings served to finance a significant part of the expansionary budget of 2009.

It is worth noting that a significant part of the 2009 fiscal expansion followed the regular institutional process. The National Congress approved the budget at the end of 2008, and later passed special measures not contained in the budget, such as the stimulus plan of January 2009 and the supplementary measures announced in May 2009. These latter policies were financed using a mix of government funds previously invested abroad and the issuance of treasury bonds.

Chile has a strong presidential regime and a heavy centralist tradition. The majority of fiscal spending is driven by central government decisions. As a consequence, there is no significant cross-level burden sharing between the central government and the regions, or privileged regions in terms of the funds allocated.

[33] J. Rodriguez, C. Tokman and A. Vega, "Structural Balance Policy in Chile".

In much the same sense, the measures contained in the government's stimulus plan pursued general goals instead of favoring specific agents or interest groups. The majority of the measures implemented were focused on low-income households and small to medium-sized companies, regardless of the economic sector to which they belonged. Again, there was little of a discretionary nature in the government's policy of funds allocation.

The government's commitment to end its temporary policies after the crisis is highly credible. On the one hand, the measures were clearly announced and designed this way. On the other hand, both the government and the central bank have invested in building solid reputations in past years. The strict adherence to the fiscal rule and the presence of a truly independent central bank have played a tremendous role in creating these conditions.

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

After the stimulus plan launched in January 2009 and the supplementary policies announced in May of the same year, the government has undertaken no subsequent fiscal measures. This results in part from the fact that the National Congress must approve any new measure. The central bank has greater freedom to pursue new action. However, aside from its progressive reduction of the interest rate and its commitment to provide liquidity, no other significant policy actions were implemented by the monetary authority.

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

Chile has an extremely sound banking and financial market. This is largely the result of outstanding prudential regulation and skilled regulatory agencies. In practice, the financial sector has operated normally during 2009, without significant failures of any kind. This is why no institutional changes, either in terms of the collapse of important market actors or of new regulatory and supervisory policies, arose during 2009.

7. Tentative Economic Impact

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

In real terms, the real expansion of fiscal spending during 2009 is expected to reach 14.5 percent. This growth can be broken down as follows:[34]

- 5.7 percent from the fiscal budget approved in 2008;
- 5.0 percent due to the stimulus plan announced in January 2009;
- 1.0 percent as a result of the supplementary fiscal measures adopted in May 2009; and
- 2.8 percent resulting from unanticipated inflation during 2009.

During 2009, the effective implementation of the fiscal budget was relatively more rapid than in the previous year. By June 2009, 51.6 percent of the fiscal budget (as compared to 48% for the same period of 2008) and 58.4 percent of the stimulus plan had already been implemented. This underlines the fact that the additional fiscal funds allocated truly acted to provide a prompt economic stimulus.

[34] Finance Ministry, "Informe de Evaluación de la Gestión Financiera del Sector Público en 2008 y Actualización de Proyecciones para 2009," www.dipres.cl/572/articles-47877_doc_pdf.pdf (accessed November 2, 2009).

Assessing the economic impact of the measures undertaken is a difficult task because of the lack of a counterfactual. Moreover, there are no fiscal multiplier estimates for the Chilean economy. Thus, only some rough estimates can be made.

Public spending represents nearly 21 percent of the Chilean GDP. In this context, the real fiscal expansion of 14.5 percent slated for 2009 corresponds to nearly three percent of GDP. On the other hand, tax deductions included in the stimulus plan account for 0.75 percent of GDP. All in all, the combined effect of higher fiscal spending and tax deductions is expected to represent about 3.8 percent of GDP during 2009. The figure is in line with the IMF's estimates on the additional fiscal deficit to be accumulated by the G-20 as a whole during 2009.[35] Assuming a fiscal multiplier on spending and revenue of 0.8,[36] the contribution to growth of the Chilean fiscal policy during 2009 may have provided three percentage points of extra growth.[37]

In the labor market, the 100,000 jobs created by the stimulus plan should have translated into a reduction of 1.4 percentage points in the unemployment rate.

Some of the sectors expected to respond more vigorously to the type of policies implemented are indeed showing signs of recuperation. Between the third quarter of 2008 and the first quarter of 2009, gross capital formation (not seasonally adjusted) exhibited a decline of six percent. During the second quarter of 2009, the drop was only two percent. Along the same line, the annualized monthly variation in supermarket sales was only 2.6 percent during the first half of 2009.[38] This contrasts with 7.6 percent year-to-year sales growth observed during July.

However, the building industry still shows mixed results. During the fourth quarter of 2008, new building authorizations (not seasonally adjusted) declined by 3.6 percent on a year-to-year basis. In the second quarter of 2009, this figure grew by 3.3 percent, but contracted again by 14.2 percent during the third quarter of 2009. Sales of new houses in the Santiago region (which accounts for nearly 60% of the country's population) declined by 34 percent and 26 percent during the last quarter of 2008 and the first quarter of 2009,

[35]According to the IMF, overall fiscal deficit in the G-20 will increase from 1.3% of GDP in 2008 to 5.5% in 2009. See "IMF Update on Fiscal Stimulus and Financial Sector," April 2009, http://www.imf.org/external/np/fad/2009/042609.pdf (accessed November 2, 2009).
[36]Of course the precise number is part of the academic economic debate. Estimates range from 0 (John Cochrane); 0.8 (Robert Barro); 1 (Robert Hall); 1.5 (Paul Krugman). The IMF (2009) estimates considers two cases: i) fiscal multipliers of 0.3 on revenue and 1.1 on spending; ii) fiscal multipliers on revenue and on spending of 0.8. We assume this last view.
[37]According to the IMF, using fiscal multipliers for spending and revenue of 0.8, the fiscal policy contribution to growth in the G-9 countries should be around 2.5 percentage points. See IMF, "The Size of the Fiscal Expansion: An Analysis for the Largest Countries," February 2009, http://www.imf.org/external/np/pp/eng/2009/020109.pdf (accessed November 2, 2009).
[38]Instituto Nacional de Estadísticas (INE), http://www.ine.cl/canales/chile_estadistico/estadisticas_economicas/supermercados/series_estadisticas/series_estadisticas.php (accessed November 2, 2009).

respectively, but rose by 11 percent in the second quarter of 2009. Even if a recovery in sales emerges, this should not have a short-term impact on GDP. Indeed, the building industry accumulated large inventories before the crisis. The stock of new residential housing respectively represented 18 months and 17 months of sales during the last quarter of 2007 and the first quarter of 2008. These figures increased to 23 months of sales and 27 months of sales during the fourth quarter of 2008 and the first quarter of 2009.[39]

On the other hand, the Monthly Index of Economic Activity (IMACEC), a monthly estimate of GDP growth, exhibited an average annualized contraction of 2.43 percent and 4.5 percent during the first and second quarters of 2009, respectively.[40] The last data available as of this writing showed some signs of a reversal of this negative trend. During the third quarter of 2009, economic activity declined by 1.3 percent. In addition, the most recent forecasts of the central bank projected an economic expansion between of 4.5 percent and 5.5 percent for 2010. These figures are in line with IMF forecasts that Chile would be one of the countries leading the region's recuperation.

Confidence has also improved in recent months. Entrepreneurial confidence as measured by an Instituto Chileno de Administracion Racional de Empresas (ICARE) survey fell to a low of 38.22 points in January 2009, but climbed back to 49.73 points in August 2009.[41] A consumer expectations survey carried out by the University of Chile also showed significant improvement in households' confidence during June 2009. Finally, CEP's opinion survey reflected that in November 2008, only 16 percent of people considered that the forthcoming economic situation would be better. This figure rose to 46 percent in the August 2009 survey.

As previously mentioned, approval ratings of the major economic authorities have also climbed to historic highs. President Bachelet reached support levels of 72 percent during August, while her finance minister is largely above 60 percent. The same survey showed that 64 percent of people approved of the government's management of the economy, and that 55 percent strongly agreed with the special stimulus measures undertaken to counteract the crisis.

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[39] The data is available at the Camara Chilena de la Construcción, www.cchc.cl/estadisticas/estadisticas.asp (accessed November 2, 2009).

[40] Central Bank of Chile, "Informe de Política Monetaria," September 2009, 24, www.bcentral.cl/publicaciones/politicas/pdf/ipm092009.pdf (accessed November 02, 2009).

[41] For details, see Instituto Chileno de Administraction Racional de EMpresas (ICARE), "Indicador Mensual de Confianza Empresarial," www.icare.cl/imce/IMCEDiciembre2009.pdf (accessed November 2, 2009).

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

Structural distortions

There is little room for structural changes produced by the economic policies implemented to face the crisis. As previously mentioned, the measures are temporary and the economic authorities have high levels of credibility. Second, the policies implemented did not introduce distortions in specific economic sectors. Rather, they have tended to be based on general principles rather than favoring specific industries or interest groups. Third, the measures implemented benefit from a substantial record of sound macroeconomic policy, including a structural fiscal rule, current fiscal surpluses during recent years, low levels of public debt and a positive net asset position by the public sector. These facts have meant that the stimulus plans could be financed without generating any fiscal or macroeconomic imbalances.

However, two of the measures adopted deserve some comment in terms of potential adverse signaling effect. The first is the indirect financial help given to building and real estate companies through the state-owned bank BancoEstado. As seen above, the building industry entered into the crisis in a situation of overstock. The sector was experiencing a boom before the crisis started. Thus, providing special government financing was not expected to increase employment, but to serve as an instrument allowing firms to diminish their stock. More important, the signal given is that the state is assuming part of the risk of a private business, thus potentially encouraging more risk-taking by this sector in the future.

The second measure subject to some criticism was the $400 million subvention to public transportation contained in the fiscal stimulus plan. It appears that this subvention was more a response to the severe problems experienced by the new public transportation system implemented in Santiago City (Transantiago) than a true stimulus-oriented measure. The subvention to public transport was extended to the national level as a consequence of the lobby exerted by the regions during parliamentary discussions originally focused on additional public funds for Transantiago. Interestingly, this $400 million was part of a much broader project on public transportation subventions introduced in the National Congress at the end of 2008. Indeed, the $400 million included in the stimulus package of January 2009 was conditional on the approval of that bill. The project was finally approved in August 2009. It resulted in subventions for public transportation of $3.6 billion (2.5% of GDP) through to 2014: one half for Santiago and the other half for the regions. Thus, what was a primarily a Santiago problem due to a mistaken public policy ultimately cost double what would have otherwise been the case, because of the need to assign similar funds to the regions in order to ensure approval of the package by the National Congress.

8. Concluding Remarks

Because of its high global integration, both in terms of trade and capital markets, Chile was quickly and deeply affected by the external crisis. For the first time since the Asian crisis growth will be negative in 2009. At the time of writing, official growth estimates range between -1.5 percent and -2 percent for that year.

In contrast to the Asian crisis, when the government's response was slow, this time both the government and the central bank reacted quickly and in a coordinated fashion. In January 2009, the central bank began an aggressive expansionary monetary policy and committed itself to provide liquidity to the market. The same month, the government launched a robust and large stimulus plan ($4 billion, or 2.8% of GDP), mixing increases in government spending and tax cuts. All in all, fiscal spending would grow by 14.5 percent in real terms during 2009 (3% of GDP), while tax cuts would total 0.75 percent of GDP, thus having a combined effect of 3.8 percent of GDP. This was largely possible because of the country's sound fiscal administration, based on a countercyclical structural fiscal rule, which allowed the country to have large savings. In addition, the plan was transparently announced and technically justified. Its main goal was to protect unemployment, assist low-income households and ease credit access for small and medium-sized companies.

Analysts, economists and the political parties shared the government priorities and approved its policies. This was a crucial aspect in its rapid approval by the National Congress. The measures were also largely approved by civil society groups. As a result, the popularity of President Bachelet and her Finance Ministry climbed to historical highs.

The robustness of the financial and banking sector also played a key role during this crisis. No significant disturbances appeared in the domestic financial market, in the form of banking failures or financial problems by other important actors. This stability was largely the result of a record of outstanding financial supervision developed in the wake of the 1982 financial crisis.

While it is difficult to measure the efficacy of the emergency measures implemented, both the fiscal plan and monetary policy certainly contributed to counteract the real effects of the financial crisis. The fiscal policy on its own (more spending plus tax deductions) would have contributed an estimated three extra percentage points of higher growth during 2009, and shaved 1.5 percentage points from the unemployment rate. Expectations are recovering, and economic growth forecasts are optimistic. It is expected that Chile's economy will grow by nearly five percent in 2010, thus leading recuperation within the region.

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

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