What's Happening to South America's *Wunderkind?*

The Americas

By Sebastian Edwards

In the midst of East Asia's currency crisis, analysts have been surprised by Latin America's relative resilience and by the absence of a major contagion effect in the region. In particular, Brazil—long considered the hemisphere's most vulnerable country—seems to be fending off the crisis.

In recent weeks, however, analysts have voiced concerns about Chile's economic future. Suddenly, Latin America's star performer is seen as weak and vulnerable. On Jan. 12 Merrill Lynch's Emerging Markets Daily talked about "Chile's tarnished miracle." In discussing its 1998 global investment strategy, ING Barings has said that it is "unconvinced that Chile is well positioned to be a market leader." Some in Wall Street circles have even spoken of a possible downgrading of Chile's debt by the international rating agencies.

To be sure, Chile is highly exposed to East Asia—more than 30% of its exports go to that region—and the price of its main export, copper, has plunged. But to conclude from this, as some in the financial press have intimated, that the economy is sinking requires a remarkable leap in logic that is not justified by current developments.

In spite of the severity of the external shocks, and of the somewhat uncoordinated policy responses, Chile's main problems are not related to the immediate future—after all, fundamentals remain strong, and the banking system is among the healthiest in the world—but to its medium- and long-term growth prospects.

Chile's splendid performance of the last decade—gross domestic product has grown at almost 7% per annum, while inflation has declined steadily—has been the result of three interrelated factors. First, productivity growth has been formidable; second, domestic savings have increased rapidly, allowing the country to expand investment greatly; and third, the labor force has been used more effectively. Recently, however, productivity improvements have slowed, savings have declined, and the labor market has become increasingly strained.

If these frailties are not addressed promptly and with vigor, the current short-term difficulties stemming from the East Asian crisis could become longer-term impediments for sustaining the successful development of the last dozen years.

Aggregate productivity improvements—arguably the most important force behind growth—are directly related to an economy's degree of market orientation and openess, and the strength of its institutions. Countries that have fostered private competition have tended to outperform those that have neglected market reforms. Likewise, countries whose institutions protect property rights and reduce the costs of innovating do better than those that have weak institutions. The key to sustained performance is to keep moving toward greater competition, continuously reducing regulation and strengthening institutions.

Chile has not ignored this. Much of the impressive productivity gains achieved in the 1985-97 period have been the result of the drastic reforms initiated in the mid-'70s. This market-oriented modernization process resulted in the much heralded privatization of social security, the creation of an agile capital market, the reduction of import protection, and the modernization of the tax system. However, after almost two decades of unrelenting reforms, the Chilean modernization effort has slowed.

Privatization and regulatory reform constitute some of the most important productivity-enhancing market reforms. Except for some important advances in infrastructure concessions and in telecommunications, Chile has made limited progress in these areas in the last three years. In spite of growing evidence of inefficiencies and accusations of corruption, the government has refused to consider even the partial privatization of the copper giant Codelco or the national petroleum company Enap. There has been no word on privatizing the state-owned television network, clearly not a crucial bit of infrastructure.

Eduardo Frei

Moreover, regulations protecting the property rights of minority owners continue to be fragile. This became apparent in 1997, when top executives of the electricity holding company Enersis allegedly benefited from the sale of a controlling stake to Spain's state-owned Endesa at the expense of minority shareholders. Unless property rights protection is firmly established it is unlikely that investment will increase sufficiently to ensure rapid and sustained growth.

On the international trade front, the administration of President Eduardo Frei has defied its own promises to further open the economy. The authorities have given a series of unconvincing explanations for this policy paralysis. First it was that existing tariffs would help the country in North American Free Trade Agreement negotiations. Then, when it became apparent that "fast track" negotiating authority would not pass in the U.S. Congress, fiscal motives were invoked. Whatever the excuses, Chile's degree of integration to the world economy has not increased significantly in the last few years. Today Chile's average degree of protection remains high—a statutory 11%—and the policy of signing multiple bilateral free trade agreements has created serious distortions in the form of trade diversion.

The increase in domestic savings in the 1985-95 period has been one of Chile's most impressive achievements. This remarkable accomplishment has been the result of the 1981 social security privatization, the 1985 tax reform that encouraged business savings, and of continuous fiscal surpluses attained since the mid-1980s. However, after reaching a peak of 27% of GDP in 1995, savings have slightly declined in the last few years. The Frei administration has reacted to this worrisome trend with a throwback to the era of big bureaucratic government: It has appointed a commission to study the issue. Although there is still no official word, rumor has it that the main recommendation will be to increase forced savings. A serious approach to the problem would rely on further tax reform and economic incentives that induce people to save.

The Chilean authorities have argued that the East Asian crisis has forced them to take an unwanted course of action. This view, however, may lead only to Band-Aid policies in reaction to an emergency. Instead, the crisis should be seen as an opportunity. By regaining the reform momentum, Chile can dispel any doubts about its longer-term growth prospects. If this opportunity is missed, Chile runs the risk of being yet another miracle-to-be that couldn't follow through. The question is whether the needed political leadership will emerge to trump frivolity and short-term politics.

Mr. Edwards is a professor of international economics at UCLA's Anderson Graduate School of Management.