

# Chile: Thrift and the Earthquake

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The ease with which Chile has financed its way through the global recession and the ravages of an 8.8-magnitude earthquake shows the value of thrift in good times. It also suggests some inflation risk over time.

Chile is borrowing \$1.5 billion in the New York market this week to help pay for the cost of rebuilding from a major earthquake and tsunami in February that killed 521 people, devastated parts of the country south of Santiago and was followed by a nationwide electrical blackout. Reconstruction could run upwards of \$30 billion, or 17% of GDP. Because Chile has managed its finances so well for so long, it can well afford to take prompt action. However, a key question for investors is whether all this new financing will eventually trigger an outbreak of inflation.

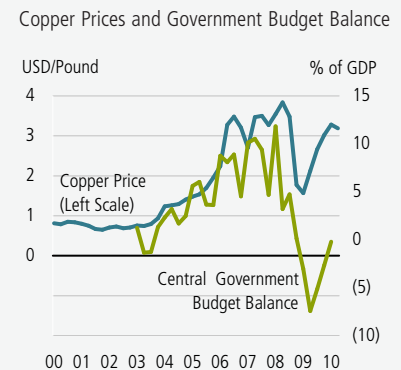
Chile has developed the institutions of a developed economy, and, unique among its commodity-producing peers, it has managed to save much of the windfall produced from the recent boom in the price of copper, its flagship export. These savings are the result of the government's balanced-budget rule, adopted in 2001. With the understanding that the copper-price spike was likely temporary, the rule mandates that government spending remains roughly equal to long-term copper prices, as estimated by

an independent commission of experts. As a result, Chile generated substantial budget surpluses, averaging around 8% of GDP during 2006–2007, when copper prices were nearing \$4 per pound (**Display 1**).

When the global recession hit, Chile was exceptionally well equipped to ride out the shock. Like many emerging markets in the region, Chile slashed interest rates and let its currency fall to cushion the recessionary blow. But, of these countries, only Chile was prepared for a massive swing into fiscal deficit, as its stimulus efforts were financed through the drawdown of one of its offshore sovereign wealth funds, from \$20.2 billion at year-end 2008 to \$11.3 billion at year-end 2009.

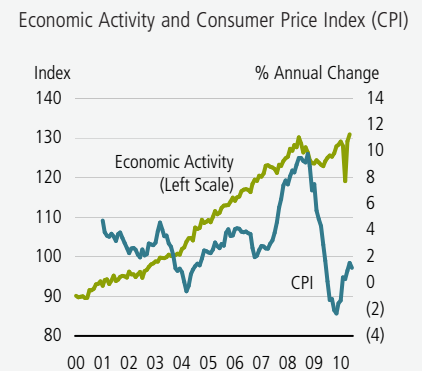
By early 2010, copper prices and Chilean output had rebounded to prerecession levels, and the government's budget was nearly in balance, or down almost 7% from the prerecession surplus. This deterioration was roughly similar to that experienced in the US during the same period.

Display 1  
Fiscal Balance Is Built on Copper



Source: Banco Central de Chile, Haver Analytics, International Monetary Fund and Ministerio de Hacienda

Display 2  
Inflation Is Unstable



Source: Banco Central de Chile, Haver Analytics and Instituto Nacional de Estadísticas

However, just as it was beginning to emerge from recession, Chile was hit by the earthquake. The Piñera administration, with its supply-side inclinations, had just been voted into office, promising substantial tax cuts. Now, the new government must pay for an existing deficit, new tax cuts and reconstruction from the earthquake while attempting to bring the structural budget back into long-term balance in four years.

Over that four-year period, earthquake-related public-works spending for roads, schools and hospitals could total an estimated \$8.4 billion, while the new administration's proposed tax cuts are estimated to cost about \$9.3 billion. To balance the budget in that time frame, the administration will need to borrow a total of \$20.1 billion.

To meet this need, the government is counting more on debt issuance and less on its sovereign wealth funds. It is also relying on a variety of budget cuts (or "reallocations"), temporary tax increases

on targeted consumption items, and an expected boost in economic growth from its supply-side efforts. It sold \$3 billion in local bonds in the first half of 2010. Chile's foreign bond issuance this week is part of this funding plan, and promises to be the first in a series of annual bond sales of similar size over the next few years.

Chile is borrowing, but its financing capacity is strong. The real question is whether the spending supported by this borrowing will strain the country's price stability. Under an inflation-targeting central bank, inflation in Chile had been well behaved, with expectations increasingly fixed at the central bank's target for inflation of around 3%. In 2007, however, politicized concerns about the currency's high value influenced policy, so official rates were not raised as quickly as necessary. The result was an unexpected surge in inflation to 9% in 2008, as global commodity prices soared. By 2009, however, global recession had led to deflation, reversing some of the damage **(Display 2, previous page)**.

While Chile is well positioned for an orderly return to financial balance, there is a possibility that the recovery could turn inflationary. The country appears well on its way back to full potential output, particularly if allowance is made for the capacity lost in the earthquake.

Chile was already using fiscal and monetary policy to push for an early economic recovery before disaster struck. Its central bank is going to have to be very careful over the next year or so to ensure that the surge in activity does not set off another exaggerated inflation cycle like the one in 2008–2009. ■

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