

Financing Reconstruction

The first thing is to reallocate part of the fiscal year budget already approved for 2010. A second natural source of financing is internal debt, in a limited way of course, in order not to affect in excess the domestic interest rate levels. Finally, the use of the foreign currencies accumulated at the Economic and Social Stabilization Fund (FEES), a real insurance that we have at our disposal.

The discussion on how should we finance the country's reconstruction, after the devastation produced by the earthquake on last February 27th, has started. The Government has just given an estimate of the earthquake's costs, and the amount corresponding to public infrastructure is around US\$10,000 millions. Nevertheless, there is still no payment schedule available, which is a key point to fully sizing the problem. What is clear, though, is that any proposal shall take into account the country's current macroeconomic situation and its medium-term goals.

The Government's actions may decisively determine not only the environment in which the productive activities shall recommence and the short-term expenses, but also the incentives to achieve the rebuilding of the country's productive capacity, allowing us to regain high and sustained growth rates at medium term.

The macroeconomic background

In the last 20 years, the country's economic activity has increasingly shown lower growth rates, in the same way as the total growth of the production factors. Furthermore, in the last four years, the productivity decreased not at the expected annual average of 0.5%, which was also set forth in the economic program of President Sebastián Piñera, but at a disturbing 1.6%; this estimate was based on the experts' opinion of the Consulting Committee of Trends in GDP from the Ministry of Finance, according to a report of this State Department from October, 2009 (see Table 1).

The dramatic average productivity decrease of 1.6% of the last four years is a true economic disaster that we are inheriting from the Bachelet administration. If, to this catastrophic starting point, we add the earthquake of February 27th, it turns out to be imperative not to get distracted from the President's promises concerning a 6% average annual growth and the creation of one million new employments, which will bring us closer to the ambitious goal of becoming a developed country in 2018.

In the short-term, economy had been recovering strongly from the subprime crisis both at its activity and consumption levels, facing later the devastating telluric movement. This earthquake, apart from destroying a significant part of our stock of capital assets (the Government has just given numbers around US\$21,000 millions), brought to a standstill different productive activities and complicated the logistics and distribution chain of an important area of the country. Moreover, the earthquake and its aftershocks have caused a feeling of insecurity that is affecting them. All this has resulted in a change of priorities by the Government and great part of the economical agents. This does not mean that the investment or consumption plans are not going to take place, they have only been postponed, we hope, for a couple of months.

It is of vital importance to rekindle these plans of sustained employment and growth over time and that the Government shows the correct signals, in order that its performance is not yet another source of worry for the production agents. This is especially valid in the light of the productivity figures from the Bachelet administration, mentioned above.

Table 1
GDP and productivity growth in Chile

Term	GDP Growth (% var., average)	Productivity Growth (% var., average)
1990-93	7.6	2.3
1994-99	5.4	1.5
2000-05	4.3	0.1
2006-09	2.8	-1.6

Source: Self-preparation based on the Expert Panel of the Consulting Committee of Trends in GDP from the Ministry of Finance, Public Finances Report of the Public Sector Budget Law Project 2010, DIPRES, October 2009.

The earthquake took place when the country was coming out of a fiscal expansion of 17.8% during 2009, an unknown figure in our recent history, which, besides causing a downturn in the effective exchange rate, obliged to an important restrictive turn, even in the pre-earthquake situation.

However, there is not only bad news in relation to the recovery of the productive capacity. Chile has low interest rates, both domestic and external. The Chinese economy keeps demanding copper, thus allowing us to benefit from its high prices. There is also a high local financing capacity due to the volume of our capital market, and abundant external financing thanks to the excellent country rating of Chile. The nation relies on a copious foreign currency level which is placed at the Economic and Social Stabilization Fund (FEES), and, finally, the State owns different tangible assets that could be sold partially or totally to the private sector.

Financing Formula

All kinds of financing proposals have arisen in this macroeconomic scenario, a true feast to finance reconstruction with the money of others.

It is already clear that this tragedy will demand an extra fiscal spending in relation to the original estimate for 2010, but the important thing is to keep this spending transitional and discreet, so as not to affect the medium-term macroeconomic balance. If this is not the case, a tax increase would be required.

This is precisely one of the motions that draw most of the attention of the media. A tax increase could turn into a shot at the feet of reconstruction, as it is not strictly necessary in the present situation of great comfort in view of the resources available, and it could clearly impair the recovery efforts of the country's productive activity. Furthermore, it could seriously damage the future growth capacity of the economy. We must not forget that part of the lost productive capacity has to be replaced by production increases in other sectors and regions that were not affected by the earthquake, because these will naturally take time to have their productive system working again.

It is well known that once you increase taxes, they are not reduced, so we must consider it the last alternative of the financing formula.

This is especially relevant in view of the technical inconsistency between an eventual tax increase and the persistent productivity drop. This explains itself not only by its direct effect on the economy, but also by the consistency signal in the direction of the economic policy as a whole given by the new administration. In this circumstance, if the management pattern of the economic authority is perceived as excessively "pragmatic", the

consistency signal shall fade away and, probably, the logical investment and global growth plans will be affected.

It should be stressed that any financing program must be necessarily flexible, in order to adapt it to the prevailing market conditions when the payments are effectively required. This is highly important, considering that variables such as interest rates and exchange rates are daily and significantly influenced not only by local events, but also by the strong fluctuations of the foreign markets.

The first thing is to reallocate part of the fiscal year budget already approved for 2010. An amount of US\$733 millions has already been announced in this sense. These resources are bound to cause a neutral impact on the effective exchange rate if they come from lesser recurrent expenses.

A second natural source of financing is internal debt, in a limited way of course, in order not to affect in excess the domestic interest rate levels and, therefore, not to delay the rebuilding process of the productive activity. The information on the placement, in the local market, of the long-term private debt during 2010 indicates that there will be at least US\$2,000 millions less issues of corporative debt than in 2009. This means that the capital market offers the opportunity to borrow funds, without putting pressure on the interest rate increase. This is possible while the private sector does not initiate a period of strong investment on reconstruction, which requires financing again. In order to pay this greater borrowing in advance, it is possible to sell partially or wholly certain state-owned assets, which brings a direct positive impact on a higher level of productivity.

The productivity drop of 1.6% in the last four years is a disaster which, together with the traumatic and complex situation of the productive capacity rebuilding after the earthquake, calls for authorities to give clear and unmistakable signals concerning issues such as the reconstruction financing.

The third financing source is the cautious use of the foreign currencies accumulated at the Economic and Social Stabilization Fund (FEES), a real insurance that we have at our disposal. In this sense, we must always be careful not to adversely affect the exchange rate, so that the exports sector and substitute of imports is not impaired in its efforts to recuperate the productive capacity.

An adequate coordination between the Ministry of Finance and the Central Bank, as it was during the recent subprime crisis, is essential in choosing the correct dose of each one of these financing formulas. It is also important to generate an enabling environment in the country so that the

economic agents may act at their full capacity and, here, the Government must play a key role.

To sum up, the productivity drop of the last four years (of around 1.6%) represents a true productivity disaster which, together with the traumatic and complex situation of the productive capacity rebuilding after the earthquake of February 27th, calls for authorities to give clear and unmistakable signals concerning issues such as the reconstruction financing.

In this sense, it is advisable to talk less about policy changes that cause the economic agents to worry, such as the tributary discussion, and to focalize instead on the priority of reconstruction, employment, productivity increase, growth and social protection.

In short, the consistency of the signals concerning the direction of the economic policy is a key point for the success of the medium-term investment and growth plans and, from there, the accomplishment of becoming a developed country in 2018.