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The Chilean Economy: From Crisis to Stagnation

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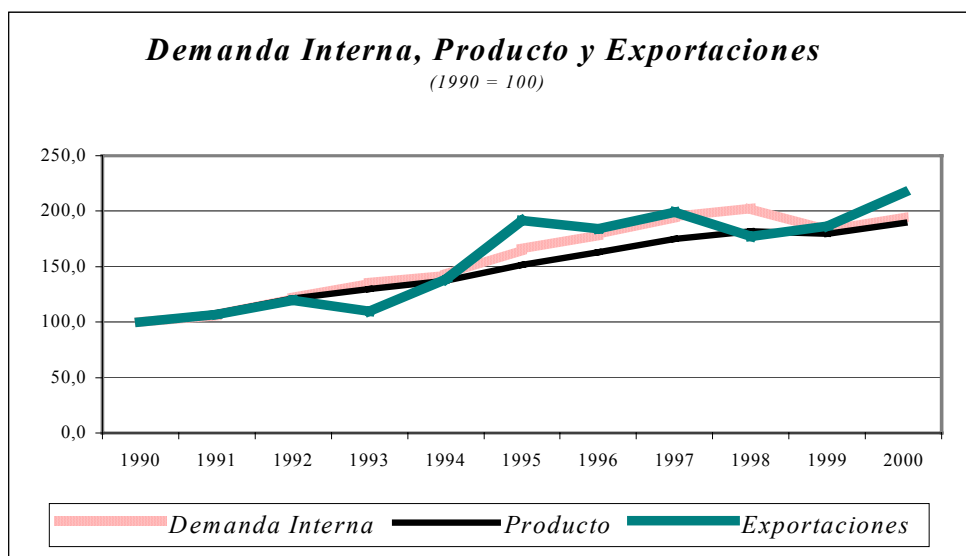
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The Chilean Economy: From Crisis To Stagnation¹

I. Background: Crisis Following One Decade of Growth

During the last decade the progress of the Chilean economy was characterized by dynamic activity, strongly linked to the performance of exports. While production rose at an annual rate of 6.5% during the period, exports rose by 8.4%. Similarly the [Fixed Capital Brute Formation] saw a 7.5% average annual expansion over the same time frame. It is this movement within the export world that sparks interior economic demands, which reach an annual expansion of 6.7%. This figure translates to 872 thousand new jobs and a 30% increase in salaries during the decade of expansion.²



In actuality, from a production standpoint, the principal contributor to the growth in internal production was the Commercial sector, accounting for 18.8%. The Industrial sector follows with 15%, just barely ahead of the Financial Services contribution of 14.8% of the GNP. In general, this positive movement was part of a decade in which inflation was clearly in decline, dropping from as much as 27% to a rate of 4.5% in 2000.

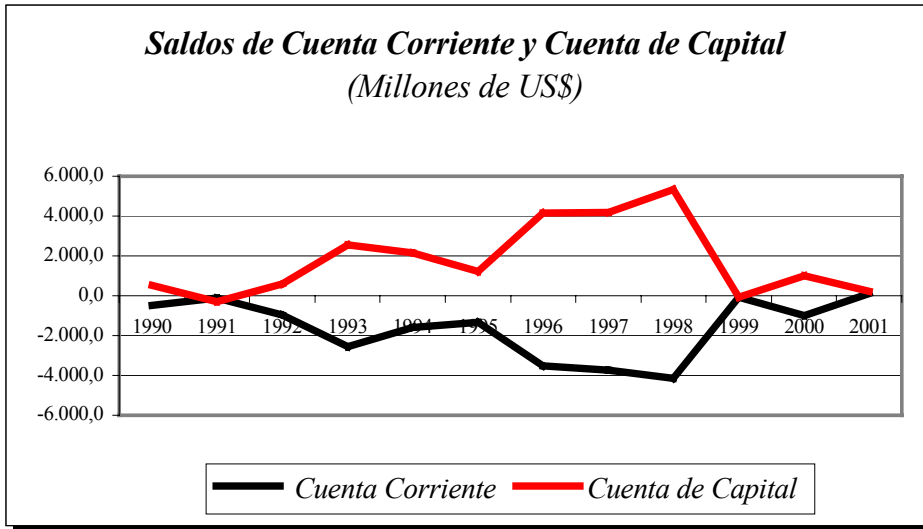
Nonetheless, during this period of growth the Chilean economy showed certain vulnerabilities, which would manifest themselves strongly with the increased internal instability, linked to the so-call Asian crisis. What was originally a latent problem quickly

¹ This piece received invaluable assistance from Manuel Hidalgo, Raul Gonzalez, and Luis Hidalgo

² The background given, as well as the statistics for the charts, come from the Central Bank of Chile [www.bcentral.cl] and the National Institute of Statistics [www.ine.cl]

became a glaring imbalance, visible most strongly in the deficit of the current account. In 1998, this deficit reached a sum of 4.144 million dollars, which represents 6.3% of production.

While this situation reached its deepest depths toward the end of the decade, it is a crisis that was in the makings for quite some time. It simply did not manifest itself earlier due to the unusual influx of capital, mainly in the form of foreign direct investment aimed at mining, which led to an increased balance in the capital account.



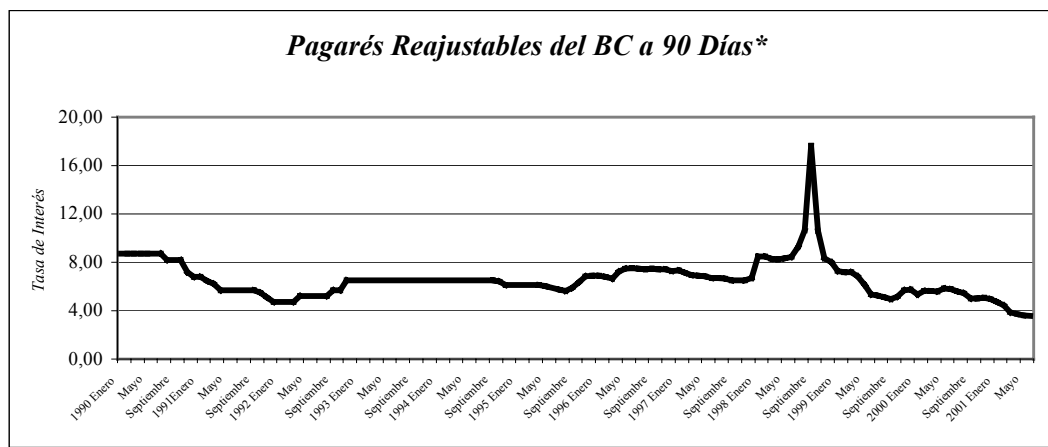
The Chilean economy was left exposed by these events to a sudden crisis, which in this case was precipitated by the sudden interruption of resources flowing into the country. This interruption occurred when investors and their capital quickly pulled out of the emerging economy after the Brazilian and Russian crises of 1998. Left behind was

this country's economy, which spends more that it earns, and had stayed afloat due to external support.

While it is impossible to find a definite causation between these events, a correlary relationship certainly exists that shows us the enormous effect that external influx has on the deficit of the current account, through a progressive exchange appreciation process.

The Chilean economy reponded to the fall in exports and foreign exchange by displaying recessive trends. Faced with a debt made untenable through the lack of foreign investment, the choice was made to adjust the interest rate in order to control internal prices. The result was a full-fledged recession, which lasted four trimesters in 1998 and 1999. These events laid the foundation for the present state of the Chilean economy.

With the choices made during this crisis, two fundamental facts emerged. The first has to do with the role of the Central Bank and the manner in which it maintains control over the fluctuation of prices. We are left with a situation that would have been untenable in the past, where the bank has the task of acting in the interest of internal demand through a monetary contraction while also trying to control the current account deficit and maintain control of inflation.

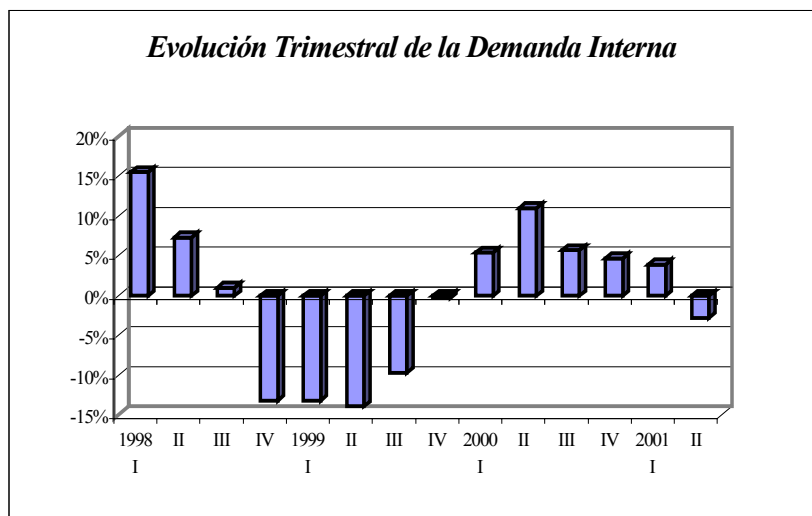
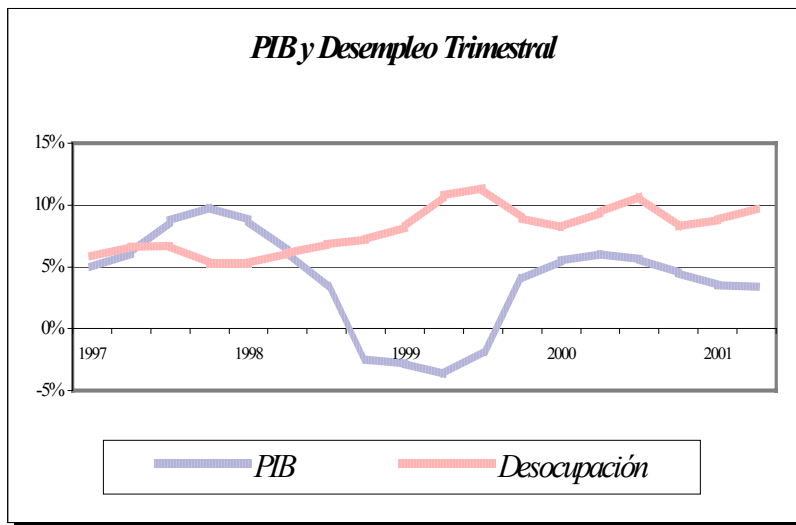


(*) Los PRBC a 90 días reflejan el comportamiento de la Tasa de Instancia Monetaria que fija el instituto emisor.

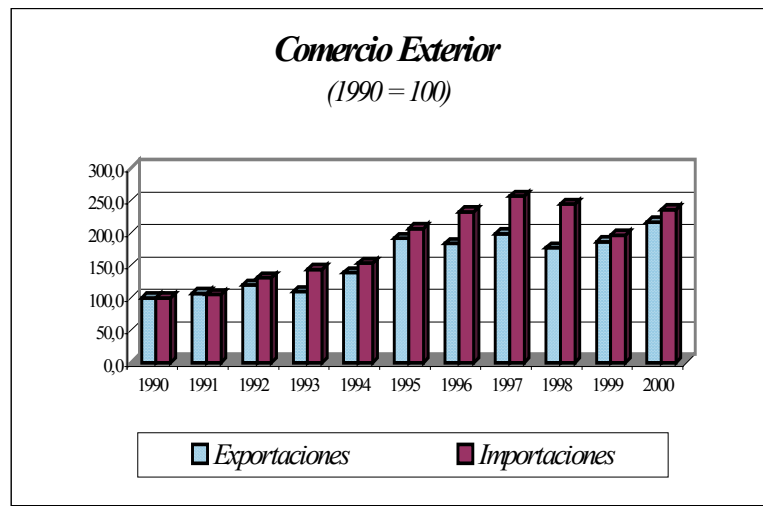
The other new reality is even more complicated, and has to do with the declining status of major factories in Chile, who in the face of a declining currency increasingly found themselves in debt to foreign capital. Given these circumstances, the governing body chose to cause a recession in order to adjust internal demand and the current account deficit.

II.- The Chilean Economy After the Crisis

The Chilean economy has met a number of obstacles in its efforts to ignite a recovery after the 1998-1999 recession. Post-crisis, the economy finds itself in a state of stagnation, resulting in an increased unemployment level, which is practically double that of 1999 rates. All of this is occurred while another economic slowdown emerged over the final three trimesters of 2000.



Two central themes have emerged from this situation: the nature of internal demand and the tendencies of economic activity, both of which seem to be tied to the economic recovery felt in 2000. If unemployment appears to be one of the main manifestations of the economic crisis and subsequent stagnation, the performance of internal demand can be used as one of the indicating variables to measure actual economic activity.

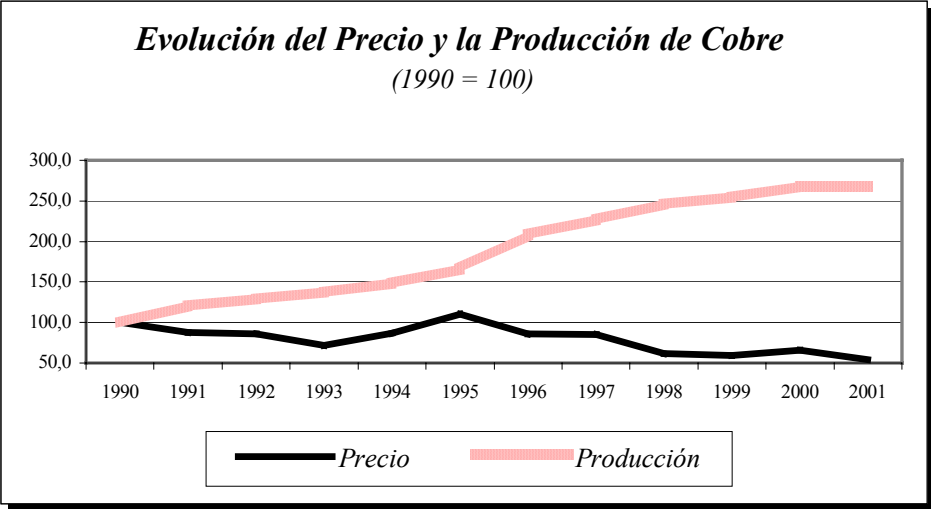


Economic performance and internal demand, shown in the above charts, have clearly slowed down. Nonetheless, while there are indications of a step backward on the road to recovery post crisis, these charts in fact reflect a larger positive trend. It is already known that in the first trimester of 2000 demand and activity recovered from the previous period, with a growth of 5.5% and 5.4% respectively. This leads to a GNP growth of 5.4% compared to the -1.1% decline of the previous year. Much of this activity and growth, though, is found in the external realm, such as the development of exports. Thus, despite the apparent recuperation felt in 2000, unemployment levels remain at levels comparable to those during the crisis. Again, the internal demand shows signs of shrinking.

The loss of activity within the external sector, as shows, reflected the deep contraction following the Asian crisis. In 1998 total Chilean exports declined by 11% from the year before. At the beginning of the decade, some 26.8% of Chile's exports were sent to the Asian market. This number rose to 34.4% in 1995, then fell to 30.8% in 2000. This drop reflects the effect the crisis in that region had on the nation's economy. As noted earlier, in the year 2000 Chilean exports rose by some 13.6%. This was in the context of a general worldwide economic growth, and an economic expansion for the country's main business partner. The United States underwent a 5% growth that same year, which had important implications for Chile, who sends 17.3% of its total exports to that country.

Given these facts, it becomes apparent that the greatest risk to the Chilean economy is the manner in which it is so tied to the performance of exports. This leads to two main threats to the economy. The first is the fluctuating performance of the worlds top economies, such as the United States, Japan, and Germany, with which Chile had a drop in export activity. In the first semester of 2001, Chiles total exports increased by only 3.1% compared with a 13.6% rise the previous year.

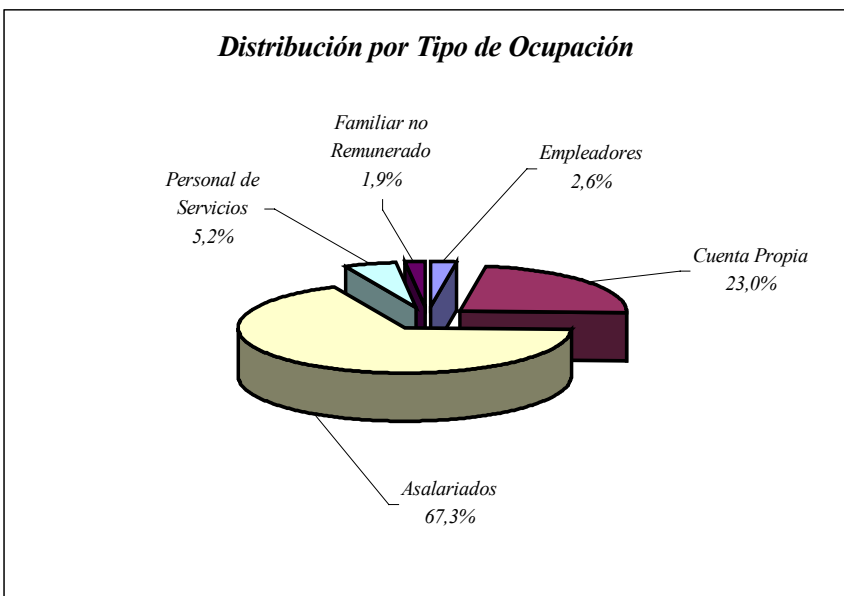
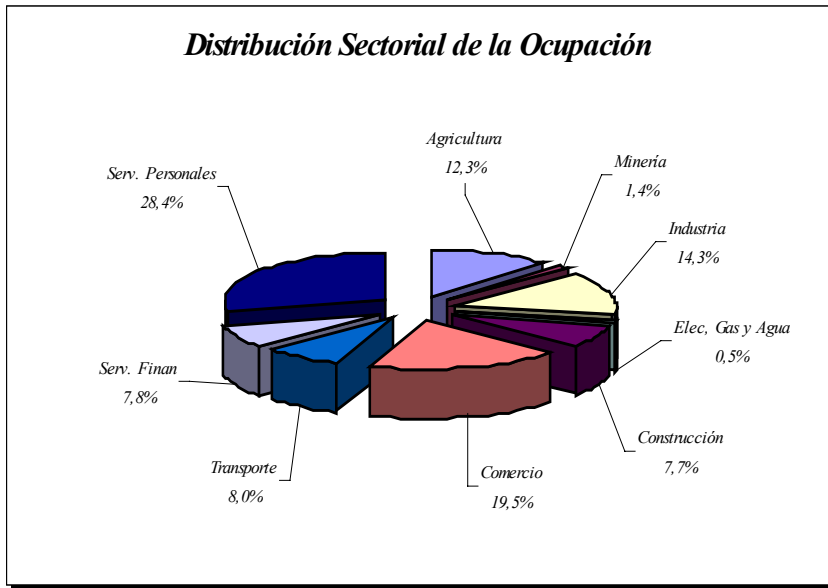
The second threat is the performance in the world market of Chile’s main export: copper. Copper represents 45.2% of the country’s total export value. This industry, mainly privately run, accounts for 36% of the world market, a situation that without a doubt makes Chile a “price setter” on the world market. Since 1990, production levels have nearly doubled to 4,380,000 tons, which has in turn driven the price down from 120 cents per pound to the current rate of 67 cents.



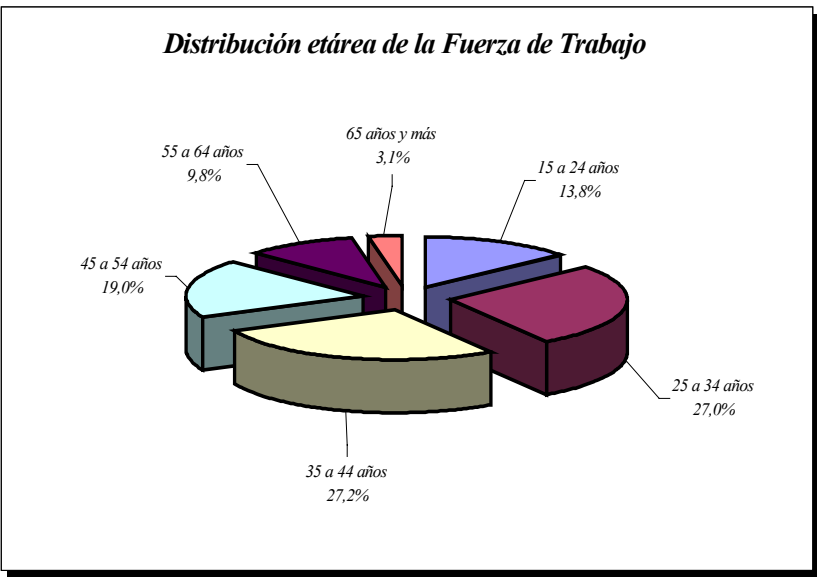
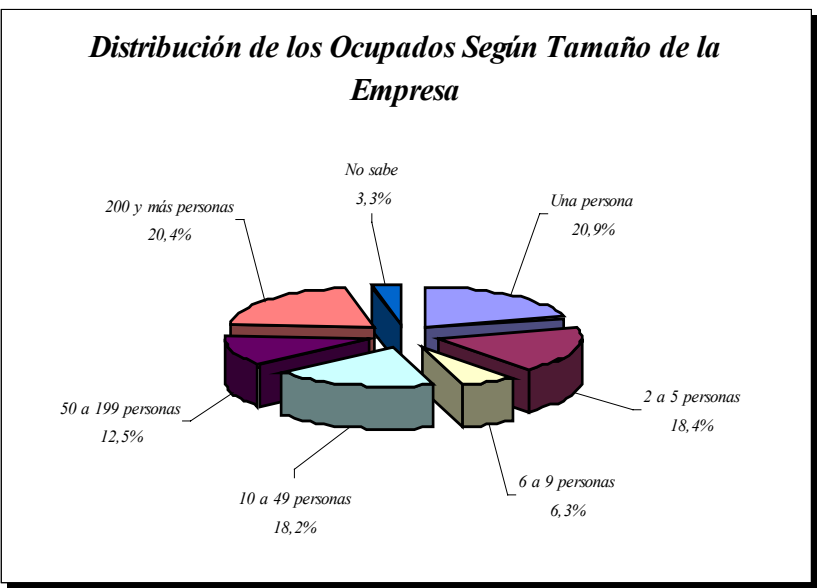
The impact of fluctuations within this market cannot be understated, as it is predominantly responsible for the State’s income and has a large influence on market performance. The response of private companies, responsible for two-thirds of copper production in Chile, to falling prices has been to increase production levels, which has saturated the market.

III.- The Job Market in Chile

An understanding of the labor market in Chile necessitates an understanding of its structural makeup. The following graphics provide a basic profile of the market, and together paint a picture of the current state of the economy.

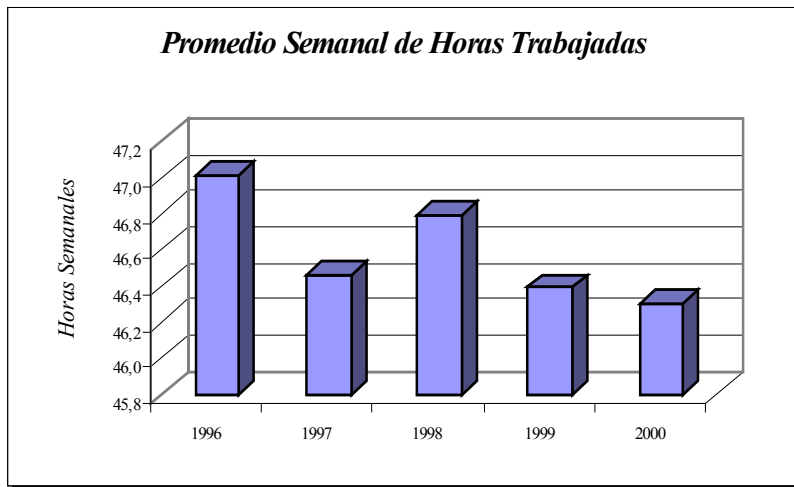
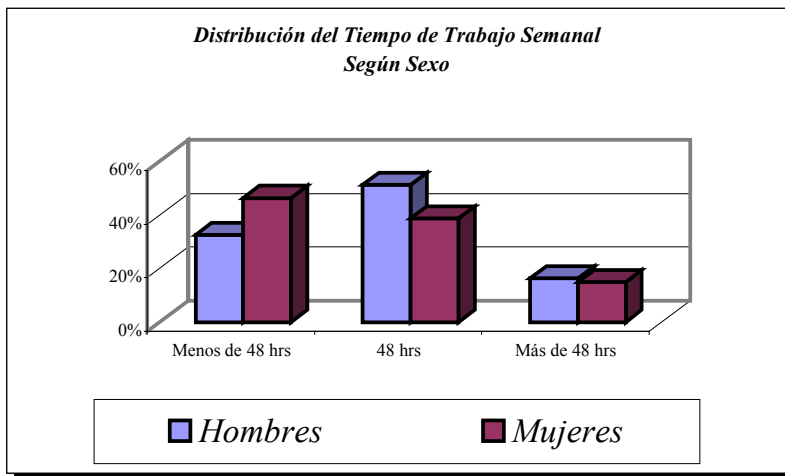


The following two labor market characteristics are particularly important: over 67% of workers are salaried and some 64% work in service occupations. The number of salaried workers, when filtered through the statistical breakdown by occupational sector, reveals a large number of company workers, almost half of whom are employed in small businesses of 10 or fewer employees. It is precisely these people who hold the jobs with the least benefits and the worst conditions, and these people are most affected by the current crisis. The high proportion of workers in the service industry is due to the opening up of the economy under military dictatorship, which saw a cutting of industrial production in favor of natural resource extraction and the service industries associated with it. In general, this situation is one that is not atypical of developing capitalist economies in third-world countries.

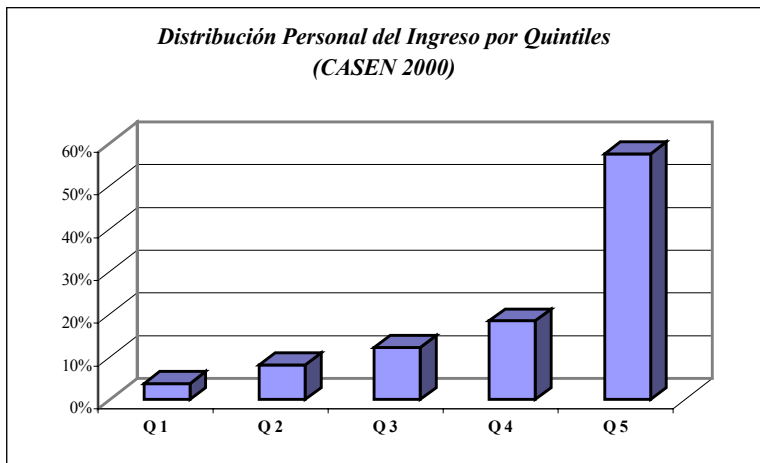
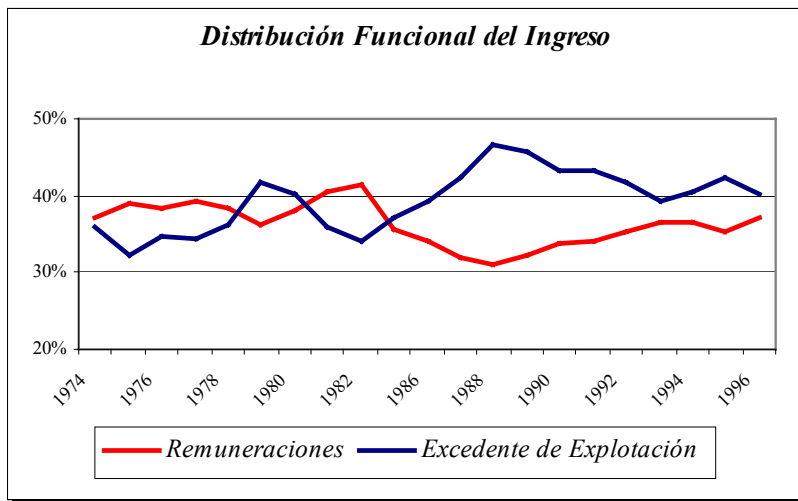


In addition, the average salary has gradually decreased in recent years, indicating a growth in part-time employment, which creates a more precarious situation for workers than full-time employment.

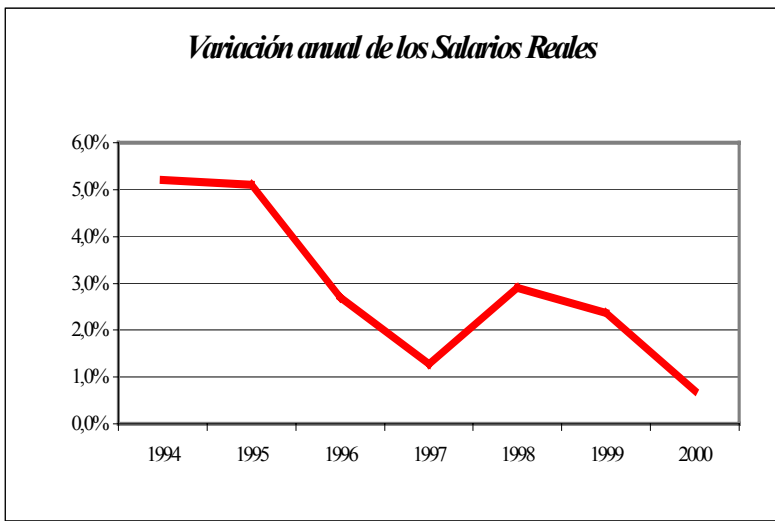
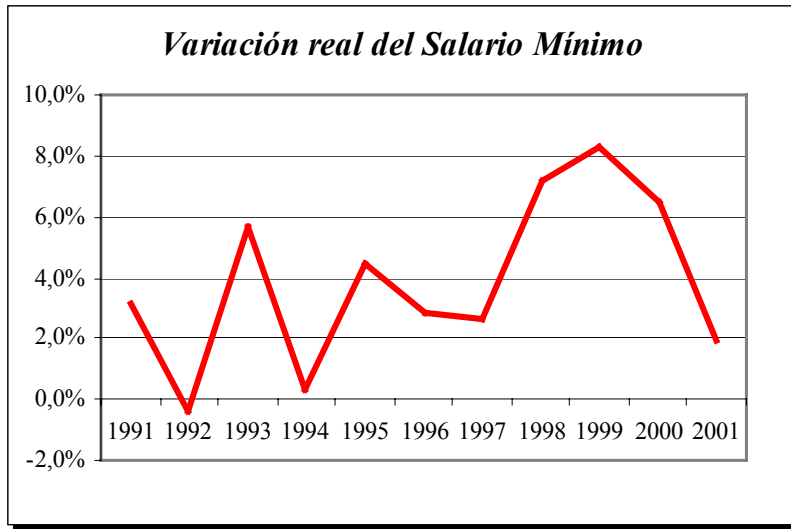
Along with the average weekly salary change is an increased participation of women in low wage and low skilled employment, indicating as much about the desperate economic situation as it does about the social restrictions Chilean women encounter.



Another important structural variable in the workforce is the distribution of wealth within the country, in other words the way in which income is distributed and how that affects each individual. Chile has one of the worst distributions of income in the world, dating back to the era of military dictatorship from which it has yet to recover. Nonetheless, during the last few years there has been a drop in the total number of people living in poverty, from 47% in 1987 to slightly more than 20% at the present time, as a result of the widening of the job market during the 1990's and an increased overall income. Despite this, given the low quality of these jobs and their benefits, distribution of wealth is still a major problem.



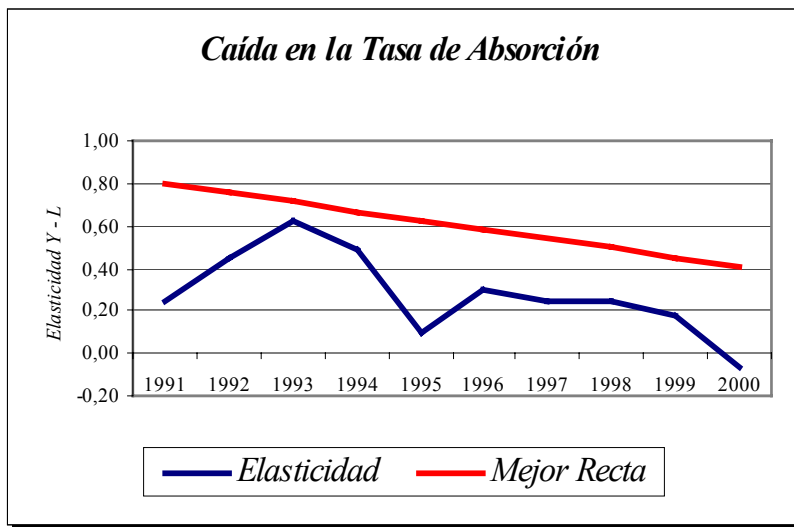
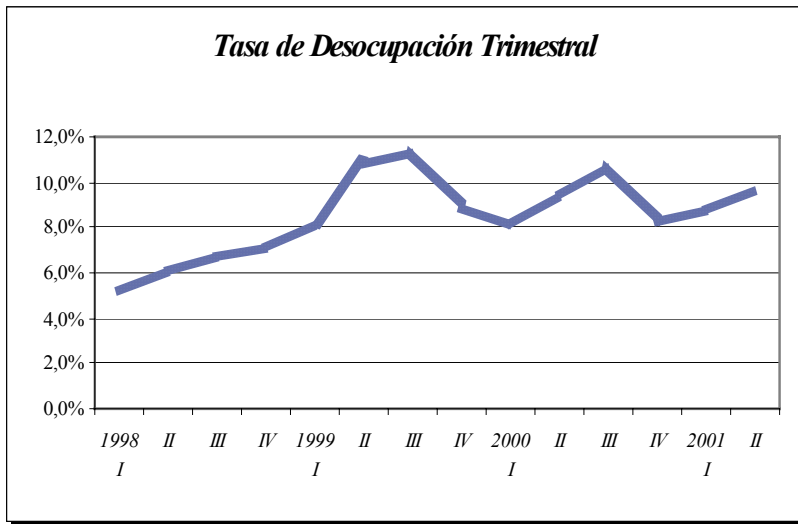
In the current shrinking economy, one of the signs of the impact on the job market can be seen in the average and minimum wages, which have experienced wide fluctuations. While in 1994 the average real salary was increasing by more than 5% per year, in this last year they have increased by only 0.7%. The minimum wage experienced an important increase during the 1990s, reaching 50% of the average actual salary, but it has not been adjusted in recent years.



This general structure of the labor market in Chile is subject to the current crisis and the stagnation that we now experience. The major roadblock to a legitimate economic recovery, such as that observed in the 1990s, can be seen in the labor market.

III.- The Persistence of Unemployment

As we indicated, persistent unemployment stands as the principal symptom along with decelerated economic activity of the current stagnation of the Chilean economy. In the first trimester of 1998, when the crisis was not yet over, unemployment stood as 5.3%, yet in this most recent trimester unemployment levels stood at 9.7%.



A major problem presents itself in the fact that unemployment has remained the same while production has increased by 5.4% over the last year. This fundamental explanation for this trend is that the sectors responsible for the recent economic growth are those of exportation, and within those the sector of natural resources, which require much less labor overall. Thus, while mining accounted for 45% of exports and 11% of production, it only accounts for 73 thousand jobs, just 1.4% of the total job market. Thus, one can see the recent economic expansion while understanding the persistence of unemployment.

By sector, it is apparent that industry, construction and mining have suffered the greatest work-force contraction. Together they have lost 220 thousand jobs, 60% of which have been in the industrial sector.

A second problem is evident in the overall inability of the Chilean economy to create new jobs and to expand, as demonstrated by the above graphic, which indicates the rate of absorption, or expansion. The general inability of the elastic job market to create new jobs is evident, and it represents a steady deterioration of the market. This, at a time of steady economic expansion.

The implications of the above examined trends can be seen in the recent debates over the nature of the standard model for economic growth in this country. If the majority of Chilean workers are employed in the goods and services sector and account for much of the internal market, we can see how poverty will continue to rise. Given the facts, it is evident that in Chile, the country can continue to experience overall economic growth while the poverty levels and the economic situation of the average citizen continues to deteriorate. In essence, then, there are two economies, one directed externally and one directed internally, each headed in different directions. It is a situation that may provide a short-term boost, but is untenable as a long-term and socially sustainable solution.

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