

**Rabobank**

Chile: Nature strikes

One of the strongest earthquakes to ever hit Chile occurred on 27 February 2010. The country's infrastructure sustained massive damage and the death toll is currently estimated around 600. As a result of the earthquake, economic activity will be subdued in the short term. However, Chile's strong economic fundamentals will allow for a rapid recovery. In this Special Report, we will go into more detail about the quake itself and its economic consequences.

One of the strongest earthquakes ever

The earthquake of February 27 measured 8.8 on the Richter scale, which made it the second strongest earthquake to hit Chile in recent history. The epicenter was just off the coast of the Muale region, in central Chile. Tsunamis following the earthquake damaged coastal towns throughout Chile. Concepción, Chile's second largest city, located at some 90 km from the epicentre was the worst affected city. Santiago, 350 km to the north, suffered relatively minor damages. Even so, buildings in the capital collapsed and southern entry roads to the city were damaged. Throughout the country, electricity companies struggled to get the power supply back online. Initial estimates of the death toll were bloated by the inclusion of missing persons. At the time of writing, the number of deaths is estimated at around 600. In addition, some 2 million people were displaced. Preliminary estimates of total direct damages range from USD 10 million (6.5% of GDP) to USD 30 million (19% of GDP).

Government response slow at first

As no less than 4 tectonic plates meet near Chile, earthquakes are not an unfamiliar occurrence in Chile. The strongest earthquake in World history took place in Valdivia in southern Chile in 1960 and measured 9.5 on the Richter scale. Since, more than a dozen strong earthquakes have hit the country.

In spite of their experience with earthquakes, the authorities were initially slow to respond. At first, the government underestimated the severity of the earthquake. This prevented an early tsunami warning going out, which could have reduced the death toll. Moreover, it took some time before a state of emergency was declared, which allowed for the use of the military for emergency relief and to guarantee security. Above all, relief efforts were, and are still hindered by the damaged infrastructure. Public unrest grew as a result, but with the help of the military the main problems were resolved.

Chile in good position to cope with impact

The earthquake in Chile was stronger than the one that hit Haiti (which measured 7 on the Richter scale). However, the situation in Chile is by no means comparable to Haiti. Even though the damage of the earthquake to the country's productive infrastructure is significant. Chile, unlike Haiti, has a strong economy with strong institutions. As a result, Chile is in a much better position to cope with the impact of the earthquake. The economy of central Chile has taken the strongest blow. In that region, the agricultural sector drives the economy. Agricultural output and trade are therefore certainly adversely affected. Moreover, Concepción is an important center for trade and services within the region. Until the city is fully functioning again, production and exports of some key commodities, such as wine, forestry and fish products, will be held back. The copper industry, which is mainly located in the north of Chile, was only slightly affected and production resumed a few days after the quake. This is fortunate, as the copper sector (through state-owned mining company Codelco) is the most important source of revenue for the government, providing between 10 – 20 percent of total government revenue. In addition, copper is

Chile's most important export product, accounting for 55% of total exports in 2009. As copper production is expected to quickly return to normal levels, the government budget and external accounts will continue to be supported by the copper sector. Nonetheless, the new president, Sebastian Piñera, will have to adjust plans for his first year in office and take into account the reconstruction effort (see also Special Report 2010/04). As a supporter of the private sector, he will involve the private sector in the reconstruction effort. He will also have sufficient means available to sharply increase government expenditures during the reconstruction phase. First of all, he will re-assign part of the earlier approved 2010 government budget to the reconstruction effort. This has already led to a USD 110 million package meant for short-term relief. Piñera announced budget cutbacks of 5% on current spending for all ministries. This will yield an additional USD 730 million that will be channeled into a new reconstruction fund. He will also be able to tap into the Economic and Social Stabilization Fund (Fondo de Estabilización Económico y Social, FEES), in which around USD 11bn of windfall copper revenues have been saved during the past years. In addition, capital markets will be willing to finance any additional debt needed for the reconstruction effort. Public debt-to-GDP is very low at 5% and Chile has a strong track-record of prudent economic policies. When taking on debt, however, the government will have to find a balance between domestic financing and external financing. Domestic financing will put upward pressure on the interest rate, which would hurt investment growth. However, external financing will decrease the competitiveness of Chile's exports because the Chilean will appreciate as a result. The government is also thinking about a moderate tax increase and the possibility of slightly raising royalties from the copper sector. Although exact measures still have to be announced, the government will likely resort to

a combination of these possibilities to pay for the reconstruction.

Economic impact

The earthquake will subdue Chile's economic performance in the short term. Real GDP growth could therefore turn negative in the near term. Food prices could spike in the coming months as a result of supply constraints. Public investment will sharply rise as a result of the rebuilding effort. This implies that the government budget deficit will not recover as expected before the earthquake, but will remain steady at around 3.5% of GDP. Meanwhile, private investment will be supported by expansionary monetary policies, which will remain in place for longer than anticipated. Monetary tightening is not expected until the end of this year. Due to the strong investment growth in the second half of 2010, real GDP growth will recover compared to last year's 1.8% contraction. However, pre-earthquake estimates of more than 5% growth are now unlikely to be achieved.

Conclusion

The earthquake that hit Chile on February 27 has brought major damage to the country's productive capital stock, which will take months, likely years, to repair. However, Chile's strong institutions and years of prudent economic management put the country in a good position for a rapid recovery. As a result, and in spite of the adverse economic impact in the short term, Chile's long-term outlook is not significantly affected.

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