

# **Employment Creation, Real Wages and Job Quality: How Much Aggregate Economic Growth Delivers? The Case of Chile**

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to stimulate discussion and obtain comments

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*Abstract:* The Chilean economy has been for the last 2 decades the fastest growing economy in Latin America, raising living standards and reducing poverty. However, economy-wide prosperity still gets short of providing enough jobs, of good quality and in fostering social integration and social fairness. This paper shows that growth-led employment creation is just moderate in Chile. Furthermore the tradable goods sector, the engine of growth in an open economy, generates only 30 percent of total employment. The period of high growth has been accompanied by a rise in average real wages of about 3 percent per year. But household surveys shows that aggregate employment growth reaches comparatively less poor households than non-poor households, while unemployment rates are much higher in poor families than in non-poor families. Also the poor tend to work more in the informal sector, a sector with lower productivity that pays lower salaries and where jobs are unstable. The paper suggests various policy options to arrive at a more inclusive and fairer pattern of growth.

*JEL classification:* E24, J21, J31.

*Résumé:* Durant ces deux dernières décennies, la croissance économique du Chili a été la plus rapide de l'Amérique Latine, avec pour résultat une amélioration du niveau de vie et une réduction de la pauvreté. Toutefois, cette prospérité économique n'a pas permis de créer suffisamment d'emplois de bonne qualité ni de favoriser suffisamment l'intégration sociale ou de la justice sociale. L'étude démontre que la création d'emploi générée par la croissance économique reste modeste au Chili. En outre, les secteurs du commerce international, le moteur de la croissance dans les pays ouverts, ne génèrent que 30 pour cent de l'emploi total. La période de croissance rapide a été accompagnée par une augmentation des salaires réels d'environ 3 pour cent par an. Mais les enquêtes auprès des ménages démontrent que la croissance de l'emploi bénéficie moins aux familles pauvres qu'aux familles plus aisées. Par ailleurs, les membres de familles pauvres travaillent davantage dans le secteur informel, où la productivité et les salaires sont plus bas et où les emplois sont instables. L'étude propose plusieurs options pour favoriser une croissance plus inclusive et plus équitable.

*Classification JEL:* E24, J21, J31.

*Resumen:* Durante las últimas dos décadas, la economía chilena ha sido la que ha experimentado el crecimiento más rápido en América Latina, tendiendo por resultado un mejoramiento en los niveles de vida y una reducción de la pobreza. Sin embargo, la prosperidad económica aún no ha conllevado la creación de suficientes empleos de buena calidad ni ha permitido la integración y la justicia social. El presente estudio demuestra que la creación de empleos generada por el crecimiento económico ha sido modesta en Chile. Más aún, los sectores orientados al comercio internacional, el motor de la economía en un país liberal, generan sólo 30% del empleo total nacional. En Chile, el período de rápido crecimiento económico ha estado acompañado por un aumento del promedio de los salarios reales de aproximadamente un 3% por año. No obstante, las encuestas de hogares demuestran que el crecimiento del empleo beneficia más a las familias relativamente menos pobres que a las familias no pobres, mientras que el desempleo es mayor entre las familias pobres que en las no pobres. Más aún, los miembros de familias pobres tienden a trabajar en el sector informal, donde tanto la productividad como los salarios son menores y los empleos son inestables. El presente estudio propone varias opciones para favorecer un crecimiento económico más inclusivo y equitativo.

*Clasificación JEL:* E24, J21, J31.

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The Policy Integration Department pursues the ILO's decent work and fair globalization agenda from an integrated perspective. Its central objective is to further greater policy coherence and the integration of social and economic policies at the international and national level. To this end, it works closely with other multilateral agencies and national actors such as Governments, trade unions, employers' federations, NGO's and universities. Through its policy-oriented research agenda, it explores complementarities and interdependencies between employment, working conditions, social protection, social dialogue and labour standards. Current work is organized around four thematic areas that call for greater policy coherence: Fair globalization, the global poor and informality, macroeconomic policies for decent work, and emerging issues. Working papers disseminate research findings at an early stage in order to obtain comments, and are thus preliminary documents.

Director: *Duncan Campbell*  
Research Advisor: *Rolph van der Hoeven*

This paper was initiated by *Rolph van der Hoeven* and *Malte Lübker*.  
It argues that more attention should be given to employment and poverty reducing policies and provides practical suggestions for an improved set of coherent policies for employment creation, better wage distribution and job quality.

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# Employment Creation, Real Wages and Job Quality: How Much Aggregate Economic Growth Delivers? The Case of Chile

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# Employment Creation, Real Wages and Job Quality: How Much Aggregate Economic Growth Delivers? The Case of Chile

## 1. Introduction

The Chilean economy has been the fastest growing economy in Latin America in the last twenty years. This has allowed raising living standards and reducing poverty; however, there remain pending employment, job quality and distributive problems. Chile's experience shows that rapid growth and greater stability are important foundations for development. However, economy-wide prosperity may still get short of providing enough jobs, of good quality and in fostering social integration and social fairness.

The Chilean economy since the mid 1980s accelerated its annual growth rate of GDP by near 2.5 percent above the growth rate of 1940-80. The increase in growth has taken place while maintaining and consolidating macroeconomic stability in terms of low inflation, fiscal solvency, balance of payments sustainability and lower public external debt. On the macro aside however, policies have not been able yet to reduce volatility of nominal and real exchange rates and dampen cycles of output and employment.

An important question is the capacity of the Chilean economy to deliver high and sustained rates of growth of employment, hopefully of good quality, accompanying GDP growth. In the 1970s and most of the 1980s, difficult periods for the Chilean economy and society, the Chilean economy operated with high unemployment rates for protracted periods of time. The correction of the high inflation of the 1970s and the currency and financial crises of the early 1980s took place through cuts in real wages and increases in open unemployment. In the 1990s, however, as a result of rapid growth, unemployment declined and real wages increased leading to welfare gains to labor. However, the evidence provided in this paper shows that growth-led employment creation is just moderate in Chile. In quantitative terms, each point of GDP growth is associated with a half-percent increase in total employment in the 1990-2005, an elasticity that is quite stable over time. Another limiting factor for employment growth in Chile is the fact that the tradable goods sector, the engine of growth in an open economy, generates only 30 percent of total employment while the non-traded goods sector creates the remaining 70 percent. The still large share of copper in total exports (a highly capital intensive sector) also contributes to this limited capacity of create employment by the tradable goods sector. In addition, manufacturing exports are largely based in the processing of natural resources with not very high value added intensity.

The period of high growth has been accompanied by a rise in average real wages of about 3 percent per year in 1986-2005. However, real wages did not increase uniformly across different occupational categories: the real wages of executives and professionals grew at a rate systematically higher than wages of both skilled and unskilled workers in the last 20 years in Chile, widening the wage scale. This confirms the presumption of inegalitarian trends in labor incomes during a period of rapid growth and globalization. In this line, the empirical evidence from household surveys shows that aggregate employment growth reaches comparatively less to poor households than non-poor households. This is for various reasons: poor families have higher dependency ratios than non-poor families; thus the income of each worker has to be divided among more family members than in the case of non-poor families in which each wage earner, on average, earns higher incomes. In fact, the earning capacity of the worker of poor household is expected to be lower than the worker, professional or executive of non-

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poor households, as education levels are systematically lower for low-income families. Finally, unemployment rates are much higher in poor families than in non-poor families. Therefore, this evidence suggests that economy-wide growth of output and employment has different welfare implications with the non-poor benefiting comparatively more than the poor. In addition, the paper shows that the poor tends to work more in the informal sector, a sector with lower productivity that pays lower salaries and where jobs are unstable.

The paper is organized in 5 sections besides this introduction. Section 2 provides an overview of the Chilean economy in the last 40 years and section 3 analyzes macroeconomic policies in the 1990-2005 period highlighting the main features of fiscal, monetary, exchange rate and capital account policies in this period. Section 4 looks at the patterns of labor market adjustment in the last 20 years in the Chilean economy focusing on the behavior of employment (aggregate and its composition) and real wages (average and for various occupational groups). Section 5 provides data from household surveys that show demographic and economic characteristics of poor and non-poor households to see how aggregate incomes trends can affect differently households and individual welfare; this section also analyzes the employment characteristics of the formal and informal sectors. Section 6 concludes.

## **2. The Chilean Economy since the 1960s: A Brief Overview<sup>1</sup>**

In the 1960s the prevailing economic model of import substitution was showing signs of exhaustion reflected in moderate growth, recurrent fiscal and external imbalances, chronic inflation and persistent inequality. The conservative Alessandri administration (1958-64) focused, largely, in managing several macroeconomic crises of different intensity but without articulating a very clear agenda of structural change of the prevailing development model. The Christian Democratic administration of President Frei Montalva (1964-70) started a program of reforms of the economy (trade reform, agrarian reform, more inclusive credit policies), along with a progressive social agenda, accompanied by growing social organization of urban dwellers and peasants. The average rate of economic growth in 1960-69 was 4.4 percent per year (2 percent in per capita terms). Inflation remained stubborn at around 26 percent per year and the country lived with chronic external and fiscal imbalances.<sup>2</sup> In 1970 the left wing coalition of President Salvador Allende, United Popular (Popular Unity), won the national elections around an economic and social program of transition to socialism (entailing nationalization of copper mines, expropriation of large industrial firms, banks and other financial institutions and acceleration of agrarian reform). The Allende government undertook expansionary fiscal and wage policies coupled with price controls. This generated a growing fiscal deficit that was financed by money creation. In 1972, repressed inflation and shortages became pervasive, starting to alienate the middle class against the government. Inflation turned into very high and open in 1973. Eventually acute internal political conflict, external covert intervention and the economic crisis led to a military coup in September of 1973 that ousted the Allende government and inaugurated 17 years of military rule, personalized by General Augusto Pinochet. In the

<sup>1</sup> This section draws on Solimano and Pollack (2005).

<sup>2</sup> A very complete reference of economic policies in the 1950-70 period is French-Davis (1973). Analysis of the Allende experience include Bitar (1975), Larraín and Meller (1990), Vuskovic (1993), and others.

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economic area, the military regime devoted to stabilize inflation (see chart 2), restituting property to former owners and securing external credits. Money based stabilization was complemented by a drastic fiscal adjustment program in which near 100,000 public employees were separated from the state sector in one year leading to a jump in the unemployment rate that remained high for several years. Trade liberalization, privatization, fiscal adjustment and market liberalization policies dominated the second half of the 1970s. An exchange rate based stabilization program was used, between 1978 and 1982, to reduce inflation, although the experiment ended up in 1982 in a severe economic and financial crisis.<sup>3</sup> The economy suffered a sharp decline of GDP, a jump in unemployment and bankruptcies, accompanied by a crisis in the banking sector, recurrent currency devaluation and serious external debt servicing problems. The crisis management of the 1982-83 economic crisis involved bailouts of firms and banks, a real depreciation of the currency that restored profitability in tradable goods activities and a cut in domestic absorption. These policies were supported by loans from IMF, World Bank and IDB. The social consequences were dire.<sup>4</sup> Unemployment climbed to near 30 percent in 1983, real wages fell and many small and medium scale firms drowned in debt or went bankrupt with the ensuing destruction of organizational capital and jobs.

In the second half of the 1980s the Chilean economy recovered supported by a more competitive real exchange rate, by the financial rehabilitation of firms, by tax cuts, easier credit and higher internal demand. However, by the end of the 1980s inflationary pressures mounted as well as external imbalances leading afterwards to the new Aylwin administration – the first democratic government elected after 17 years of Pinochet rule – to address. In addition, the Aylwin government raised taxes to fund social programs oriented to revert the social deterioration of the previous years in terms of minimum wages, reduced monetary subsidies to the poor and the chronic under-funding of the public health and education systems. Fiscal resources were also needed to start revamping public infrastructure such as ports, roads and highways deteriorated after years of little public investment. Macroeconomic policies in the 1990s (the subject of next section) accommodated higher social spending while reducing inflation, taxed short-term capital inflows, and reduced public external debt. The Lagos administration furthered conservative fiscal policies by adopting the explicit rule of fiscal surplus, achieved a further reduction inflation but suspended the tax on short-term capital inflows and supported a floating exchange rate regime with minimal Central Bank intervention.

<sup>3</sup> References of that period are Corbo and Solimano (1991), French-Davis (2002), Edwards and Edwards (1987), Solimano (1993, 1999), Foxley (1983), Meller (1997), and others.

<sup>4</sup> See Solimano, Aninat and Birdsall (2000).

**Table 1: Chile: Selected Macroeconomic Indicators, 1960-2005**

Variable	Sample period	Averages <sup>a</sup>						
		1960-2005	1990-2005	1960-69	1970-79	1980-89	1990-99	2000-05
(1) GDP <sup>b</sup>								
(1a) Rate of Growth (%)	1960-2005	4.1	5.6	4.4	2.2	3.4	6.3	4.3
(1b) Index (1960=100)	1960-2005	250.3	421.4	122.8	155.6	198.6	364.7	515.8
(2) GDP per capita <sup>b</sup>								
(2a) Rate of Growth (%)	1960-2005	2.4	4.1	2.1	0.5	1.7	4.6	3.1
(2b) Index (1960=100)	1960-2005	150.7	213.8	109.9	115.6	125.5	193.5	247.5
(3) Inflation Rate (%) <sup>c</sup>	1960-2005	50.7	7.8	24.9	175.2	20.7	10.8	2.9
(4) Unemployment Rate (%) <sup>d</sup>	1974-2005	10.1	7.8	...	12.9	12.1	7.3	8.8
(5) Fiscal Balance (% of GDP) <sup>e</sup>	1970-2005	-0.4	1.1	...	-3.3	-0.1	1.3	0.9
(6) Real Wages <sup>f</sup>								
(6a) Rate of Growth (%)	1981-2005	2.1	3.0	...	...	0.5	3.8	1.6
(6b) Index (1980=100)	1980-2005	124.1	139.2	...	...	99.9	128.3	157.4
(7) Current Account Balance (% of GDP) <sup>g</sup>	1960-2004	-3.7	-2.3	-2.3	-3.7	-7.3	-3.1	-0.7
(8) Real Exchange Rate (1986=100) <sup>h</sup>	1977-2005	87.1	93.6	...	65.1	83.2	92.0	96.3
(9) Terms of Trade (Jan 1995=100) <sup>i</sup>	1960-2005	121.4	98.3	179.1	132.5	89.5	99.2	96.7
(10) International Reserves (millions of US\$) <sup>h</sup>	1960-2005	5771.9	14045.6	62.0	451.7	3564.1	13103.8	15615.3
(11) Gross National Savings (% of GDP) <sup>j</sup>	1960-2004	15.3	21.8	12.3	12.0	11.8	22.2	21.1
(12) Foreign Saving (% of GDP) <sup>j</sup>	1960-2004	3.5	2.2	2.6	2.8	7.1	2.9	0.7
(13) Gross Fixed Capital Formation (% of GDP) <sup>j</sup>	1960-2004	18.8	24.0	14.9	14.8	18.9	25.1	21.9
(14) Exports of Goods, (% of GDP) <sup>f</sup>	1960-2004	19.3	25.2	11.8	16.0	21.4	23.3	28.9
(15) Real Exports of Goods, Growth Rate (%) <sup>f</sup>	1961-2004	7.8	9.8	3.3	8.3	8.4	11.4	6.5
(16) External Debt (% of GDP) <sup>k</sup>								
(16a) Public	1960-2003	26.9	15.4	14.8	28.8	53.5	17.4	10.2
(16b) Private	1960-2003	19.7	32.0	7.9	7.9	26.2	26.2	46.7
(16c) Total = Public + Private	1960-2003	46.7	47.4	22.6	36.7	79.7	43.6	56.9

*Notes and Sources:*

<sup>a</sup> These averages for any variable only take into account the respective sample period.

<sup>b</sup> Own elaboration based on figures from ECLAC. The GDP series are based on official figures converted into dollars at 2000 prices.

<sup>c</sup> National Bureau of Statistics and Central Bank of Chile.

<sup>d</sup> From 1974-75, Solimano and Larraín (2002). From 1976-2005, Central Bank of Chile.

<sup>e</sup> From 1970-86, Larraín and Selowsky (1991). From 1987-2004, DIPRES and own calculation.

<sup>f</sup> Own elaboration based on figures from ECLAC.

<sup>g</sup> From 1960-69, own elaboration based on figures from Central Bank of Chile and the World Development Indicators (WDI). From 1970-2001, ECLAC. From 2002-04, Central Bank of Chile.

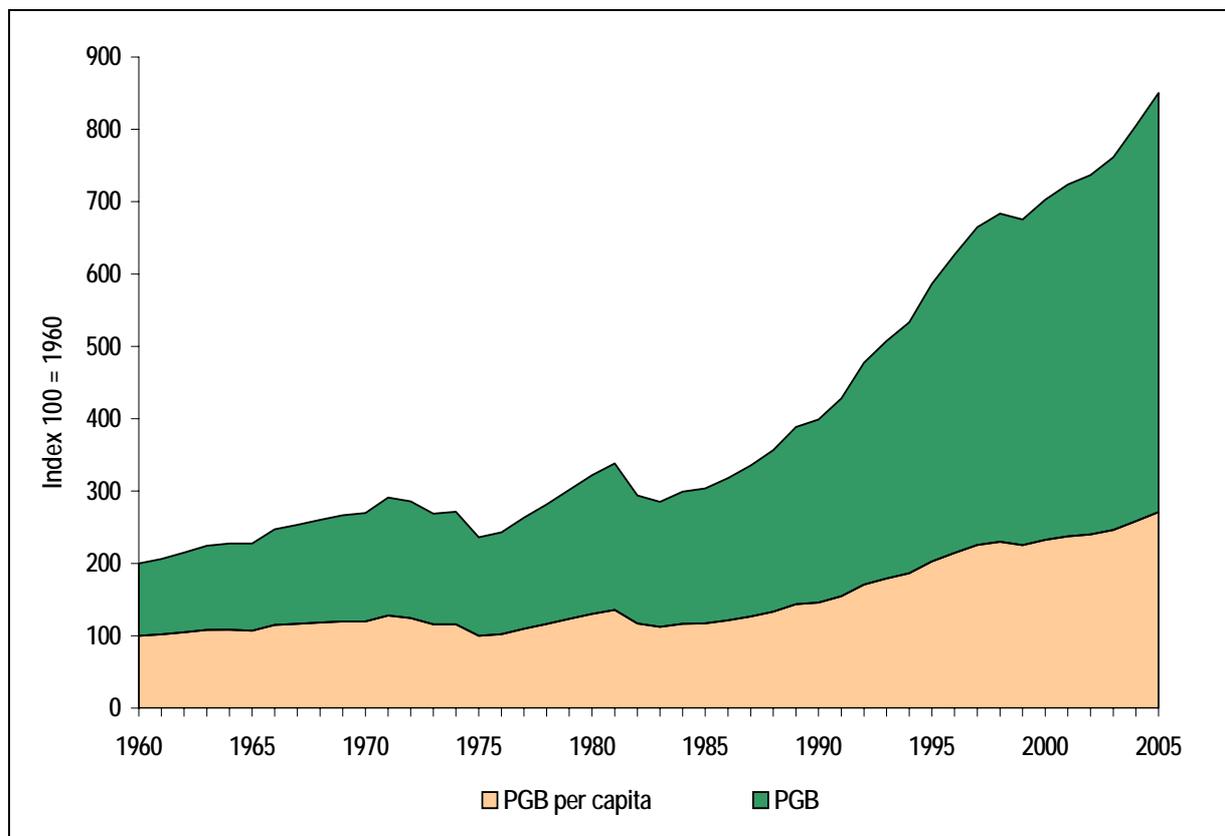
<sup>h</sup> Central Bank of Chile.

<sup>i</sup> From 1960-64, own elaboration based on figures from ECLAC. From 1965-2000, Bennett and Valdés (2001). From 2004-05, own calculation based on information obtained from the IpoM (*Informe de Política Monetaria*), Central Bank of Chile, several issues.

<sup>j</sup> From 1960-84, Bennett, Schmidt-Hebbel and Soto (1999). From 1985-2003, Central Bank of Chile.

<sup>k</sup> Central Bank of Chile (2001 and 2004).

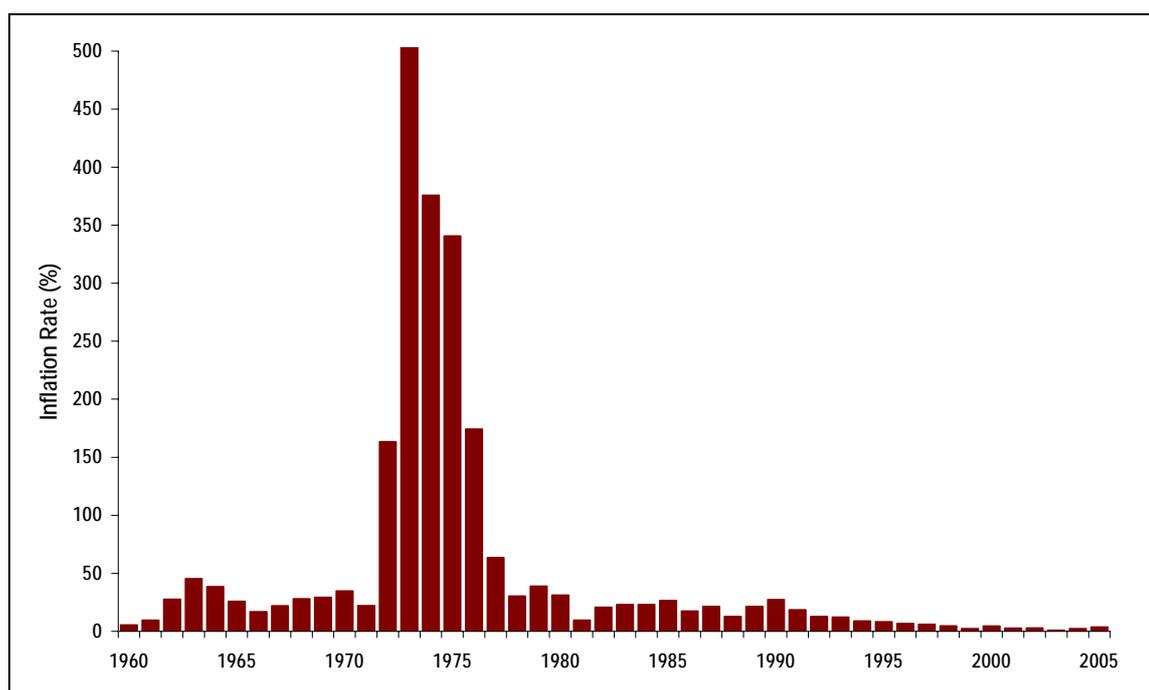
**Chart 1: Chile: GDP and GDP Per Capita Levels, 1960-2005  
(Index 100 = 1960)**



*Note:* The figures for 2005 are estimates from ECLAC.

*Source:* Own elaboration based on figures from ECLAC and Central Bank of Chile.

**Chart 2: Chile: Inflation Rate, 1960-2005**  
(% per year)



Source: Own elaboration based on figures from National Bureau of Statistics.

### 3. Macroeconomic Policies in the 1990-2005 Period

The fiscal and inflationary crises of the 1970s and the currency and financial crises of the early 1980s created a consensus on the need to ensure macroeconomic stability for development. The macro policies of the 1990s in Chile were gradualist in the anti-inflationary front and pragmatic in other areas such as the use of taxes to deter short-term capital inflows (in place until 2000). Gradualism did not preclude, however, the application of “shock treatment” in 1998 in the aftermath of the Asian and Russian crises by the Central Bank. As a consequence of the monetary crunch, interest rates soared, cooling down expenditure (particularly investment) and rising the cost of debt servicing by consumers and firms. In retrospect, it is apparent that the policy of very high interest rates turned particularly vulnerable the sector of small and medium size enterprises that were in debt and faced sluggish internal demand. This policy also led to a delayed and sluggish recovery in output and employment until 2003 a situation that started to turn around in 2004-05 following higher copper and other commodity prices.

*Fiscal Policy.* In the fiscal area the three governments of the period 1990-2005 pursued an implicit or explicit policy of fiscal surpluses, although this policy was not complied every year.<sup>5</sup> In 2000 the Lagos administration formalized a *fiscal rule* in which the government was to run a *structural* fiscal surplus of 1 percent of GDP (the structural budget is calculated using medium run projections of the main sources of fiscal revenues such as the

<sup>5</sup> Arellano (2005) provides a very good discussion of fiscal policies in Chile. He states that correcting for trend, in the 1999-2003 period there was no fiscal deficit.

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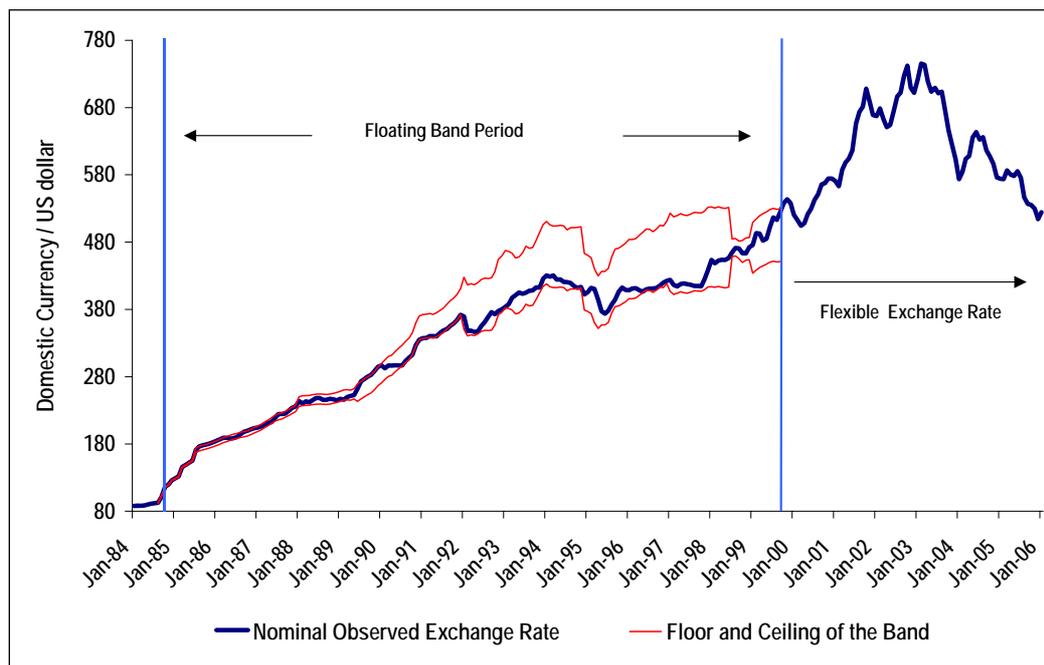
price of copper and the level and rate of growth of GDP). This rule is consistent with some degree of counter-cyclical fiscal policy as it allows the government to run deficits in years in which GDP is below the full capacity level, financed, in principle, by surpluses accumulated in good years. It is an open question the extent to which aggregate demand policies in 2000-03 were much counter-cyclical in spite of favorable conditions to accelerate a recovery of growth and employment because there was low inflation, existing unused capacity and access to external borrowing at a low cost. The stock of foreign public debt declined from 53.5 percent of GDP in 1980-89 to 10.2 percent of GDP in 2000-05 (table 1). In these conditions, more expansive demand management policies could have been undertaken to shorten this cycle of sluggish growth and slow employment creation of the period 1998-2003.

*Exchange Rate Policy.* A main shift in exchange rate policy in the last five years has been the abandonment of an “intermediate regime” (e.g. an exchange-rate band regime) for a system of free floating with minimal intervention by the monetary authorities.<sup>6</sup> In September 1999, the regime of the exchange rate band was abandoned. The management of the adjustable band regime was not simple as persistent capital inflows during most of the 1990s, mainly until 1997, exerted a “downward” pressure on the exchange rate (to appreciate) moving the market exchange rate to the floor of the band. The Central Bank engaged in expensive sterilization operations to counteract the monetary effect of massive purchases of foreign exchange. In 1998-99, a tight monetary policy was complemented by a policy of *reduced* exchange rate flexibility (that *narrowed* the band, reducing the distance between the floor and the ceiling of the band) in face of adverse terms of trade shocks and a reduction in capital inflows. In general, adjustments to adverse external shocks that are not fully financed require *more* (not less) exchange rate flexibility. Until now, under the flexible exchange-rate regime, the Central Bank has intervened in the foreign exchange market just few occasions and only under pressure for *depreciation* of the exchange rate: one in 2001 associated with a certain instability created by September 11<sup>th</sup> and the crisis of the Argentinean currency board. The other main intervention was in 2002 after turbulence linked to the Brazilian elections. In 2005 a strong tendency towards *appreciation* of the exchange rate has developed but the Central Bank has refrained from intervening. The free-floating exchange-rate regime has been associated with significant fluctuations in the nominal exchange rates (see chart 3), this volatility can be highlighted as a problem of the free-floating regime adopted since 1999. It is important to note that the path of the real exchange rate has exhibited significant changes over the years combining periods of currency depreciation (1977-78, 1982-89, 1998-2003) with periods of real appreciations (1979-82, 1990-97, 2004-05, see chart 4) driven by various factors including the size and direction of capital flows, the terms of trade and internal growth.<sup>7</sup>

<sup>6</sup> See Cornia (2005) and Williamson (2004) for analysis of intermediate exchange rate regimes.

<sup>7</sup> The free floating regime has benefited from: (a) the decline in “pass-through” coefficients between exchange rate and prices that reduces the inflationary effect of currency depreciations; (b) the small liability-dollarization in the banking system although the increase in external indebtedness of the corporate sector reduces this effect; and (c) the development of more sophisticated financial instruments to deal with exchange fluctuations, see De Gregorio and Tokman (2004).

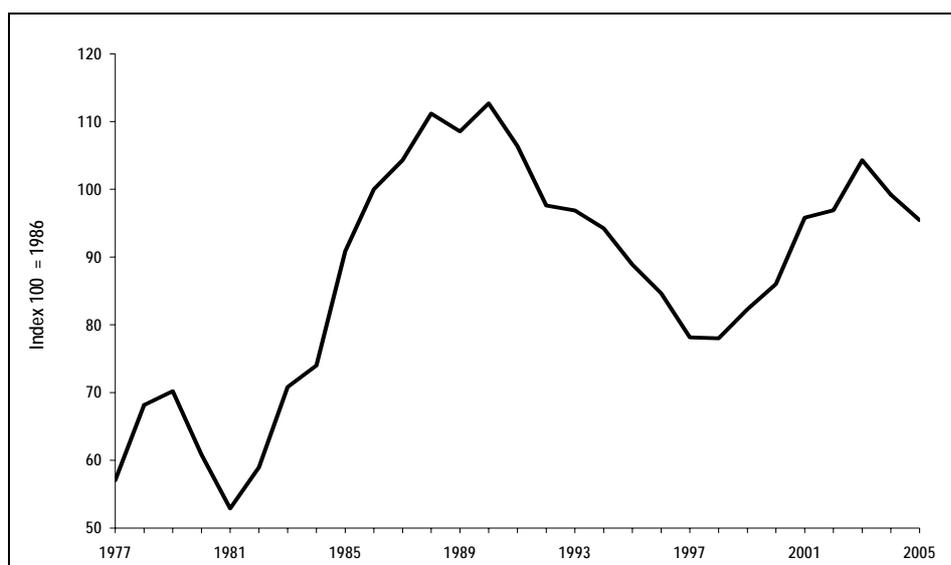
**Chart 3: Chile: Exchange Rate Regimes: Floating Band and Flexible Exchange Rate Systems Periods January 1984 to January 2006**



*Note:* Monthly average of daily observed exchange rate.

*Source:* Own elaboration based on data from Central Bank of Chile.

**Chart 4: Chile: Real Exchange Rate, 1977-2005 (Index 100 = 1986)**

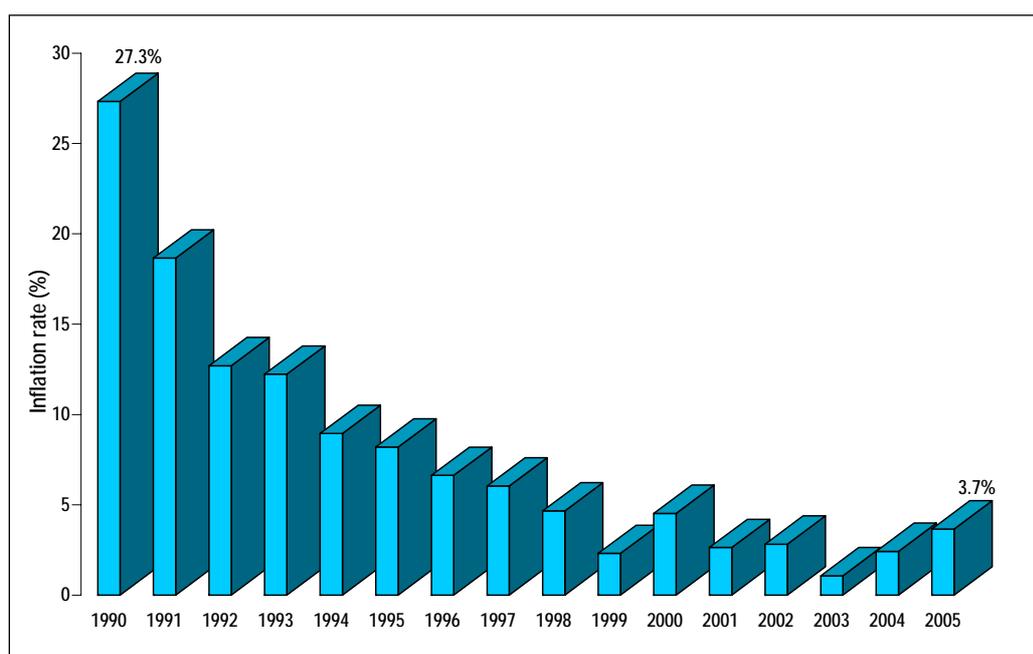


*Note:* An increase in the index indicates depreciation and a decline is an appreciation.

*Source:* Own elaboration based on figures from Central Bank of Chile.

*Disinflation and Monetary Policy.* An important policy accomplishment of the last 15 years in Chile has been the decline in inflation that fell from 27.3 percent in 1990 to 3.7 percent in 2005 (see chart 5). However, this is also part of a general shift to a low inflation regime in the world economy, a trend shared by the Chilean economy. In 2000-05 the average inflation rate in Chile was 2.9 percent a level that is very close to inflation of OECD economies. Chile instituted an independent Central Bank in the late 1980s with a mandate of ensuring low and stable inflation and normalcy in internal and external payments (as mentioned before the chart of the Central Bank of Chile, unlike that of some other Central Banks of developed economies, excludes any objective of growth or full employment in its mission).<sup>8</sup> The strong anti-inflationary mandate of the independent Central Bank also must have contributed to the attainment of lower inflation. However, as said before the policy actions of the Central Bank also affect output and employment in the short term through interest rate policy and their effects on domestic absorption (consumption and investment). As mentioned before, the 1998-99 *credit crunch* of the Central Bank and *reduced* exchange rate flexibility probably *amplified* the real effects on domestic output and employment of the external shocks associated with the global turbulence of 1997-99. Monetary policy in recent years has operated using an inflation target, as of 2004-05 in the range of 2 to 4 percent. Monetary policy has regained more autonomy with the floating exchange rates regime, although as we shall see later this has taken place in a context of large fluctuations in nominal exchange rates.

**Chart 5: Chile: Inflation Rate, 1990-05**  
(% per year)



Source: Central Bank of Chile.

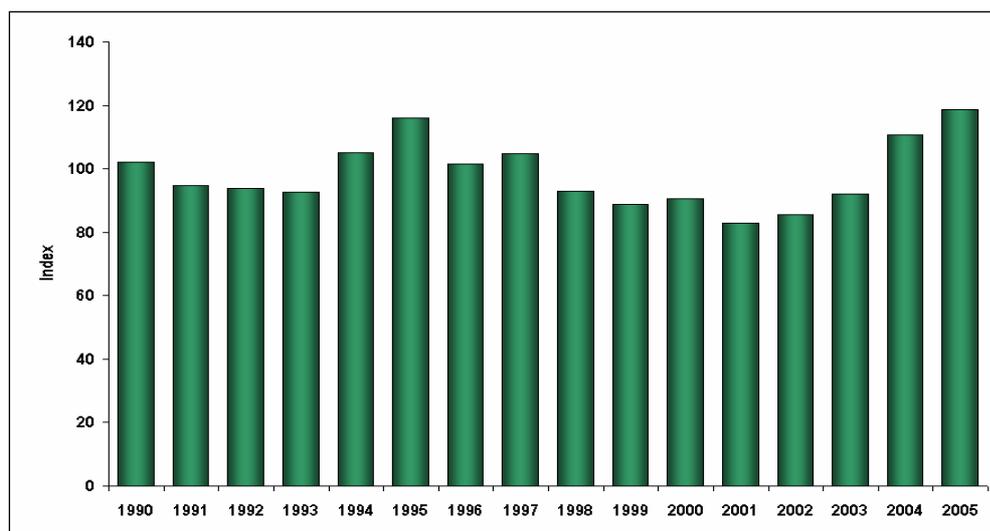
<sup>8</sup> Of course monetary authorities cannot be completely oblivious to the real cycles of the economy and the effects of its own policies on the intensity and timing of these cycles. Also as part of the accountability mechanisms the authorities of the Central Bank have to present, every year, to Congress a report on the march of the economy.

*The External Sector and Performance across Administrations.* The performance of the Chilean economy in 1990-2005 was also influenced by the cycles of the international economy, the behavior of terms of trade, international interest rates, capital flows and demand for exports. The terms of trade experienced several swings through the period with a decline in 1991-93 followed by a boom in 1994-97 and then a decline in 1998-2003 to recover again in 2004-05. The improvement in terms of trade continued further as copper prices exceeded US\$ 2 the pound in December of 2005, a record price. It is worth noting that economic activity (except in the early 1990s) followed closely the pattern of the terms of trade.

The average current deficit in 1990-2004 was 0.7 percent of GDP (see table 1), a low number by the standards of developing countries that are in a phase of their development process in which foreign savings are needed to complement national savings to support economic growth. The levels of current account deficits were higher in 1990-97 than in 1998-2004 due to rapid growth of the Chilean economy and the return of capital inflows to Latin America in those years. The concern of Chilean policy-makers in maintaining a sustainable level of absorption of capital flows was complemented by the objective of discouraging short-term capital inflows. For that purpose a tax on short-term capital was in effect until March 2000.

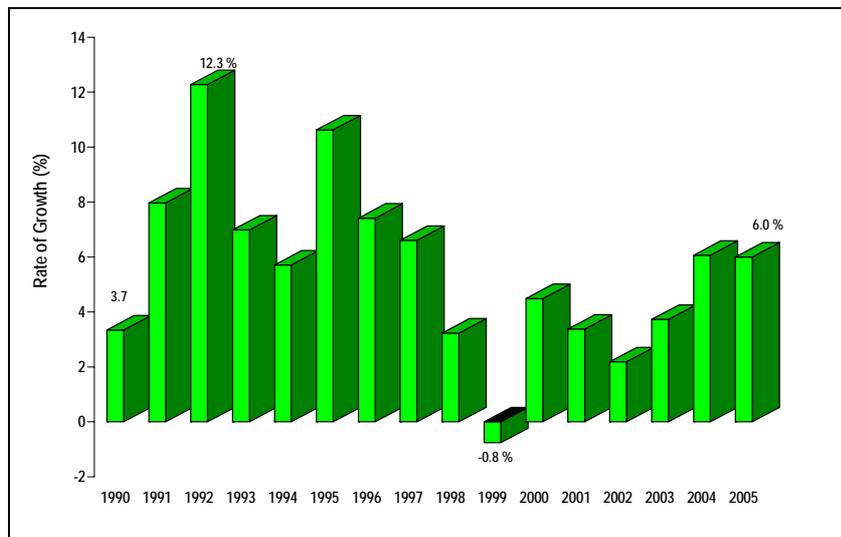
Although the total level of external debt has not changed much in the period under analysis, there has been a substantial change in its composition between public and private debt. As mentioned before, the democratic governments have followed an active policy of reducing of public external debt both in absolute terms and as a share of GDP. In contrast, private external debt increased from US\$ 5.633 millions in 1990 (19 percent of GDP) to US\$ 34,079 millions in 2004 (47 percent of GDP). We know from past experience, that when debt servicing difficulties arise there is a need of costly macroeconomic adjustment even though the debt was contracted by the private sector (i.e. that was the case prior to the crises of 1982-83 in Chile). Clearly, the Chilean economy is much more robust today than it was in the early 1980s, although a monitoring of the evolution of private external debt is advisable.

**Chart 6: Chile: Term of Trade, 1990-2005  
(Jan 1977 = 100)**



*Source:* Own elaboration based on data from Bennett and Valdés (2001) and Central Bank of Chile.

**Chart 7: Chile: Rate of Growth of GDP, 1990-2005  
(% per year)**



Source: Central Bank of Chile.

Comparing the economic performance across the administrations of President Aylwin, Frei and Lagos, we find some differences in outcomes (table 2) and in underlying macro policies (table 3). Economic growth was the highest in the Aylwin administration (1990-94) with average GDP growth of 7.8 percent per year and the lowest in the Lagos administration with average GDP growth of 4.3 percent per year<sup>9</sup> (2000-05). In contrast, inflation was the highest under Aylwin (average 17.7 annual) and the lowest under Lagos (2.9 percent annual). The macro performance of the Frei administration lies in between Aylwin and Lagos in terms of growth and inflation. Of course, initial economic conditions and the international economy affected the growth record of each administration. For example, a complicated international scenario associated with the occurrence of the Asian and Russian crises hit the Frei government in 1997-98 and also affected, to some extent, the Lagos government (until 2003). Although fiscal policy has been austere in the three governments, the lowest fiscal deficits are observed during the Lagos administration that had in place an explicit rule of a structural fiscal surplus. At the same time, fiscal policy has been only mildly counter-cyclical in his period as discussed before. Regarding labor market indicators, unemployment has been higher and real wages have grown more slowly in the Lagos administration compared to the Frei and Aylwin administrations. In contrast the lower current account deficits are experienced in the Lagos administration, which seems to have been the most orthodox in macroeconomic policy of the three-*concertación* governments. An indicator that has not receded in the whole democratic period of Aylwin, Frei and Lagos has been the persistence of income inequality with Gini coefficients in the range of 56-57 percent that are high under international standards (the Gini increased by more than one percentage point in the Frei and Lagos administrations compared to the Aylwin government). Clearly the persistence of inequality is a pending development challenge in Chile.

<sup>9</sup> This number probably will go up when 2005 is included if the forecast of near 6 percent growth realizes.

**Table 2: Chile: Economic Performance by Administration, 1990-2005**

	Aylwin Administration (1990-March 1994) <sup>a</sup>	Frei Administration (1994-99)	Lagos Administration (2000-05)
	(1)	(2)	(3)
<b>Rate of Growth of GDP (%)</b>			
- Total	7.6	5.5	4.3
- Per capita	5.7	3.9	3.1
<b>Rate of Inflation (%)</b>	17.7	6.1	2.9
<b>Real Wages (Rate of Change, %)</b>	3.7	3.8	1.6
<b>Unemployment (%)</b>	7.3	7.3	8.8
<b>Fiscal Balance (% of GDP)<sup>b</sup></b>	1.6	1.1	0.0
<b>Terms of Trade (1997=100)</b>	95.8	101.5	96.7
<b>Current Account (% of GDP)<sup>b</sup></b>	-2.5	-3.5	-0.7
<b>Gini coefficient</b>	56.2	57.4	57.2 <sup>c</sup>

Notes:

<sup>a</sup> The average corresponds to 1990-93.

<sup>b</sup> The average for President Lagos corresponds to 2000-04.

<sup>c</sup> 2000-03.

Source: Own calculations and table 1.

**Table 3: Chile: Macroeconomic Policy Matrix, By Government Administration, 1990-2005**

	Aylwin Administration (1990-March 1994) (1)	Frei Administration (1994-99) (2)	Lagos Administration (2000-05) (3)
<b>Exchange Rate Policy</b>	Exchange rate band	Exchange rate band	Floating
<b>Monetary Policy</b>	Eclectic	Eclectic	Inflation goals
<b>Fiscal Policy</b>	Austere (Without fiscal rule)	Moderately austere (without fiscal rule)	Rule of structural fiscal surplus (1% of GDP)
<b>Taxes to short term capital flows</b>	Yes	Yes	No

Source: Own elaboration.

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## 4. Growth, Employment and Labor Market Performance

In the last 20 years *the Chilean economy experienced a rapid growth process* in which annual GDP growth was 5.9 percent (1986-2005), representing a significant increase over its historical growth rate of the 1940-80 period of around 3.5 percent per year. However, the acceleration in growth rates after 1985 was not a smooth process: it was punctuated by at least three cycles<sup>10</sup>: one of rapid growth (Cycle I in table 4) lasting from 1986 to 1997, a second cycle (Cycle II) in the period 1998-2003 of slow growth triggered by the Asian and Russian crises and the domestic policy response documented in the previous section. In cycle II, GDP grew only at 2.7 per year, a drastic deceleration in growth from 7.4 percent of the previous cycle (1986-97). A new recovery in growth of around 6 percent per year in 2004-05 (Cycle III) has been led by very favorable copper prices and low international interest rates. A positive feature of these cycles is that they did take place in a context of declining inflation and, in general, a comfortable fiscal position. On the other side, the structure of relative prices changed as the real exchange rate has experienced considerable swings, particularly in the last 3 to 4 years.

*Reform in Labor Market Policies after 1990 and labor market performance.* With the advent of democracy in 1990 changes in labor market policies and legislation took place to redress the most unpleasant labor policies of the Pinochet regime that severely weakened labor unions, lagged minimum wages in real terms and maintained persistently high unemployment rates. The labor reform of 1991 eliminated the most restrictive rules on wage negotiation that could extend to industrial branches and not only firm level as during the military regime, changed legislation that restricted labor union activity and collective bargaining, increased severance payments and followed a policy of readjustment of minimum wages above average wages. Further changes in labor legislation took place in 2001-02 when unemployment insurance was created and extended labor benefits to temporary workers.<sup>11</sup> Some observers pointed-out that the policy of generous real minimum wage increases particularly in the 1998-2000 period in which there was a slowdown in growth and slack in labor markets had adverse effects on employment.<sup>12</sup>

Taking the 20 years period (1986-2005) aggregate employment grew at an annual rate of 2.7 percent per year implying an output–employment elasticity of 0.45.<sup>13</sup> This output–employment elasticity is in line with previous studies that estimate econometric labor demand functions in Chile for the 1970s, 80s and 90s (see Solimano and Larraín, 2002). The relatively low output–employment elasticity has two sides to it: on one hand it is “good news” if viewed as an increase in average labor productivity; on the other hand, it reflects a limited capacity to generate employment by economic growth. The elasticity output–employment varies (albeit not too much, see table 4) across cycles I, II and III.

*Why the output–employment elasticity is low?* The relatively modest capacity to create employment of aggregate growth may have several explanations (see also final section) such as: (i) a relatively high frequency of economic cycles that can make firms reluctant to hire more workers in good times if the duration of upturns is uncertain, (ii) a traded goods

<sup>10</sup> See Solimano (2006) for an analysis of growth cycles in various Latin American countries.

<sup>11</sup> See Larrañaga (2005).

<sup>12</sup> See Cowan et al. (2005).

<sup>13</sup> The rate of growth of employment is equal to 2.7 percent divided by 5.9 percent, the rate of growth of GDP.

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sector that is not very labor intensive, (iii) the lack of greater flexibility to incorporate part-time jobs practices for different ages groups, (iv) lack of downward real wage flexibility induced by minimum and public sector readjustment policies, (v) the existence of productivity gains that can be labor-saving, (vi) a pattern of consumption that is tilted to goods not very labor intensive and other factors.

The sector composition of employment (table 5) shows that the non-traded goods sector is the main generator of employment in Chile accounting for around 70 percent of total employment in the economy. According to the national accounts this sector comprises electricity, gas and water, construction, commerce, transportation, finance and personal services. In turn, the traded-goods sector that is supposed to be the engine of growth (but not of employment generation) comprises near 30 percent of total employment. In Chile, like in other countries, mining is very capital intensive; agriculture is more employment intensive and manufacturing in the middle. In fact, the contribution of mining to GDP is seven times higher than its contribution to total employment; in contrast, the contribution of agriculture to GDP is near one-third its contribution to total employment and the contribution of manufacturing to GDP is roughly the same as its contribution to total employment (see table 5). Still Chile has not undertaken the transition from exports dependent upon basic commodities and natural resources to more skill-intensive and technologically advanced goods.

**Table 4: Chile: Growth, Employment and Real Wages in the Chilean Economy, 1986-2005**

	Cycle I	Cycle II	Cycle III	Averages	
	1986-97	1998-2003	2004-05	1986-2005	1990-2005
(1) GDP rate of growth (%)	7.4	2.7	6.0 <sup>a</sup>	5.9	5.6
(2) Employment, rate of growth (%)	3.4	0.8	1.8 <sup>b</sup>	2.5	1.8
(3) Elasticity output – employment [(2)/(1)]	0.5	0.3	0.3	0.4	0.3
(4) Unemployment rate (%)	8.1	8.6	8.5 <sup>c</sup>	8.3	7.8
(5) Real Wages,(rate of growth, % )			(*)	(*)	(*)
General	3.6	1.8	1.8	2.9	3.0
Managers	6.1	1.7	2.5	4.4	3.6
Professionals and Technicians <sup>d</sup>	2.3 <sup>e</sup>	n.a.	n.a.	n.a.	n.a.
Professionals <sup>f</sup>	n.a.	2.9	1.3	n.a.	3.9 <sup>g</sup>
Skilled Workers	2.8	1.3	2.7	2.3	2.3
Unskilled Workers	3.9	1.5	1.6	2.9	3.0

Notes:

(\*) 2005 annual average includes figures from January until October.

<sup>a</sup> The GDP growth projection for 2005 is 6.0 percent (ECLAC).

<sup>b</sup> The figure for 2005 is the rate of growth for the moving average quarter of September-November 2005 with respect to the same period of 2004.

<sup>c</sup> The figure for 2005 corresponds to January-October (Central Bank of Chile).

<sup>d</sup> This series goes from December of 1982 to April of 1993; afterwards wages are calculated separately separated for professionals and technicians.

<sup>e</sup> Average of the period 1986-93 (April).

<sup>f</sup> This series is calculated since April 1993.

<sup>g</sup> Average of the period 1993-2005.

n.a. Not available.

Source: Own elaboration based on figures from Central Bank of Chile and National Bureau of Statistics (INE).

Average real wages grew at a rate of near 3 percent per year in 1986-2005. As usual in most cycles, real wages are pro-cyclical growing faster in cycle I (1986-97) of faster growth than in 1998-2003 a cycle of sluggish growth. Looking at the evolution of real wages for four categories: managers, professionals, skilled workers and unskilled workers we find that managers and professionals saw their remunerations increase much faster than workers' wages (both for skilled and unskilled). In fact, in 1986-2005 the real wage of managers grew 1.5 percentage points above the average real wages and 2.1 percentage points per year above the wages of skilled workers (and 1.5 percentage points above the wages of unskilled workers). The real wages of professionals in the period 1990-2005 (a period for which we have separate data of professional's wages) increased at a rate above the 'growth of the real wages of unskilled and skilled workers. As these differences in annual growth rates accumulate over two decades relative wages between workers and professional and managerial levels have been diverging over time, *widening* the salary distribution in the last two decades in Chile. In summary, labor market adjustment in the more rapid growth period of 1986-2005 is characterized by moderate job creation and unequal wage increases that benefited more the high-end labor categories of professionals

and managers than skilled and unskilled workers. In next section we will see some characteristics of the job creation process in formal and informal labor markets.

**Table 5: Chile: Shares of Traded and Non-traded Goods Sectors, 1960-2004**

Periods	Traded Goods <sup>a</sup>		Non-traded Goods <sup>b</sup>		Agriculture		Mining		Manufacturing	
	% of sector output on GDP	% of total employment	% of sector output on GDP	% of total employment	% of sector output on GDP	% of total employment	% of sector output on GDP	% of total employment	% of sector output on GDP	% of total employment
<b>1960-70</b>	36.53	47.03	63.47	52.97	7.64	26.40	8.54	3.40	20.36	17.23
<b>1970-80</b>	35.10	42.17	64.90	57.83	6.99	21.58	8.37	2.93	19.74	17.66
<b>1980-90</b>	35.26	36.10	64.74	63.90	8.24	19.45	9.51	2.24	17.51	14.41
<b>1990-2000</b>	32.56	33.77	67.44	66.23	8.04	15.96	8.73	1.76	15.79	16.06
<b>Average 2000-04</b>	29.69	28.83	70.11	71.17	4.35	13.28	7.94	1.32	15.99	14.23
<b>2000</b>	29.89	29.52	70.15	70.48	4.17	13.87	8.06	1.37	16.38	14.27
<b>2001</b>	29.85	28.79	70.46	71.21	4.28	13.22	8.24	1.35	15.95	14.21
<b>2002</b>	29.54	28.70	70.63	71.30	4.38	13.11	7.72	1.34	15.90	14.24
<b>2003</b>	29.37	28.75	70.21	71.25	4.44	13.18	7.82	1.22	15.81	14.34
<b>2004</b>	29.79	28.39	70.11	71.61	4.48	12.99	7.88	1.31	15.93	14.09

Notes:

<sup>a</sup> Traded goods are composed by the following sectors: Agricultural, Hunting and Fishing; Mining; and Manufacturing.

<sup>b</sup> The No-traded goods correspond to the sum of the following sectors: Electricity, Gas and Water; Building; Trade; Transportation and Communication; and Financial and Personal Services. Additionally, this figures includes the net VAT and the import rights.

Source: 1960-2000, Solimano and Larraín (2002). 2000-04, Central Bank of Chile.

## 5. Family Characteristics and Employment Patterns of the Poor

Let us look at now some information on socio-demographic and labor market characteristics of Chilean households of different income strata to see how macro and labor development discussed in the previous section affect average welfare levels and the income-generation capacity of individual family members. The data presented in table 6 shows several important features:

- a) Poor families are larger than non-poor families and have higher dependency ratios;
- b) Poor families (indigent and poor non-indigents) have a high incidence of unemployed and inactive members;
- c) The incidence of unemployment among the poor is closely related to their education level, which is much lower among the poor income strata;
- d) Workers coming from indigent and poor households tend to work in lower productivity sectors.

**Table 6: Chile: Socio-demographic Profile and Labor Market Indicators by Poverty Strata (Year 2000, average)**

Variables	Indigent	Poor no Indigent	No poor	Total
Number of household members	4.8	4.8	3.7	3.9
Dependency demographic rate*	75.9	70.2	50.4	54.3
proportion of inactive population	52.1	48.9	37.9	40.1
Unemployment rate	42.4	21.2	7.3	10.2
<b>Proportion of employed household members with:</b>				
- Less than 8 years of education	44.4	35.3	18.8	21.1
- Less than 10 years of education	69.2	58.9	31.6	35.3
- Less than 12 years of education	83.1	74.4	42.1	46.3
<b>Proportion of occupied in low Productivity sectors</b>	47.4	42.3	32.6	36.9

\* Ratio between people less than 15 years old and older than 65 in total population.

*Source:* Solimano, A. and M. Pollack (2005).

This data shows that aggregate employment growth and real wages increases are bound to have a lower impact on the welfare level of the “representative” member of poor household than non-poor households. This is for various reasons: (a) poor families have more members and higher dependency ratios (so the income of each worker has to be divided among more household members) than non-poor families; (b) the earning capacity of the poor household is expected to be lower than the non-poor as education levels are systematically lower for low-income families and (c) unemployment rates are significantly higher in poor families than in non-poor families.

### **Informality and Segmentation in the Labor Market**

The Chilean labor market is segmented. Firms in the formal sector have relatively higher capital and technology intensity, pay better wages and more taxes, have more formal labor relations (labor contracts and social benefits) and provide more training and better salaries to their workers.<sup>14</sup> In turn, the “informal sector”, is characterized by lower productivity firms and by more flexible entrance and exit of workers, under less formalized labor relations. Often, workers in the informal sector perceive lower salaries than workers in the formal sector, enjoy fewer social benefits and have a lower educational level. According to Infante and Sunkel, ILO, (2004):

In the formal sector around 87 percent of workers have a contract; only 50 percent of informal workers have it. Besides, 84 percent of formal sector’s workers have social security benefits, but only 35 percent of informal workers count with it.

<sup>14</sup> People working in the formal sector are identified with wage employees, employers in small, medium and large enterprises in the public and private sectors, and professionals and technicians (Infante and Sunkel, ILO 2004).

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Working conditions are worse in the informal than in the formal sector (longer working hours and less safety at the work-place).

Informal sector workers are less educated (with an average of 9.6 years of education), than formal workers (with an average of 12.2 years of education).

Poverty is higher among informal sector workers, than within the formal sector.

Additionally, women are concentrated in the informal sector, and they get lower salaries than men (20 percent lower in the formal sector and 45 percent lower in the informal sector).

In Chile a trend towards certain formalization of employment was observed during the boom of growth in 1990-97, but this trend was reversed abruptly after the Asian crisis. Since 1998 most new jobs were generated in the informal sector. At the end of the 1990s, informality was at the same level than in 1990. Table 7 shows the pattern of labor market segmentation among different income groups. While 36 percent of workers from poorest groups (1<sup>st</sup> quintile) work in the informal sector, only 3.2 percent of the richest workers (5<sup>th</sup> quintile) work in that sector. The informal sector tends to shrink, relatively, in good times and expands in bad times although changes in the legal rules governing the corporate sector and the small-medium size firms also affects the size and characteristics of the informal sector.

**Table 7: Chile: Population Working in the Informal Sector by Income Level (year 2000, %)**

<b>Income Quintile</b>						
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>Total</b>
<b>Informal</b>	36.0	28.8	16.7	13.1	3.2	16.4
<b>Formal</b>	64.0	71.2	83.3	86.9	96.8	83.6
<b>Total</b>	100.0	100.0	100.0	100.0	100.0	100.0

*Source:* Infante and Sunkel, ILO (2004).

## **6. Final Remarks: Policy Challenges Ahead**

In the last 20 years Chile accelerated its growth rate of GDP above its historical standards and consolidated macro stability in terms of low inflation, fiscal surpluses and balance of payments sustainability. However, there remain macro and exchange rate volatilities, an insufficient pace of job creation, lack of diversification of the export structure and persistent inequality. In particular, we can highlight the following policy challenges for the Chilean economy in the years ahead:

*Reduce real exchange rate volatility and the length of economic cycles:* Chile succeeded in stabilizing and reducing inflation but not in dampening volatility of the real exchange rate. A challenge is how to make more stable the path of such key relative price to avoid adverse effects for resource allocation and export development. Another feature of the growth experience of Chile is that in spite of an acceleration in growth rates in the last two decades its path has been accompanied by cycles of long duration and closely linked to changes in the international economy, terms of trade and capital flows.

*The capacity of growth to generate jobs in adequate numbers and of good quality is limited.* Augmenting the ability of economy-wide growth to generate employment in

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sufficient number and of good quality is a priority. The output elasticity of employment is around 0.5 in 1986-2005 and around 70 percent of total employment is generated in the *non-traded goods sector*. There are various reasons for the relative low output-employment elasticity: a relatively high frequency of economic cycles that can make firms reluctant to hire more workers in good times if the duration of upturns is uncertain, a traded goods sector that is not very labor intensive, the lack of flexibility to incorporate part-time jobs practices for different ages groups, the existence of productivity gains that can be labor-saving, a pattern of consumption that is tilted to goods not very labor intensive and other factors.

*Diversification of the export structure.* Chile is still dependent on a large commodity export sector such as copper that accounts for around 40-45 percent of total export revenues and is the main source of fiscal revenue. Copper, however, is a very capital-intensive sector and has moderate internal linkages to other sectors of the economy. In contrast, other tradable sectors such as agriculture and manufacturing are more labor intensive. Still, the manufacturing sector in Chile is based in the processing of natural resources (pulp, wine, wood-based products, fish meal, etc) and the country has not entered yet in a phase of export development based on high skills human resource capabilities and more sophisticated technologies.

*Unequalizing trends in wage growth and incomes.* During a period of more rapid economic growth, average real wages grew at around 3 percent per year in the 1986-2005 period. However, the rate of wage increase was not uniform for most wage categories. In fact, wages grew much faster (than 3 percent) for managers and professionals than for skilled and unskilled workers in that period. This shows a trend of widening wage inequality in a period of rapid growth and globalization. Also Chile has very stable Gini coefficients at high values by international standards (high and persistent inequality of incomes). Perhaps surprisingly, the Gini has remained with little variation in the last 15 years of high growth and more active social policies after the restoration of democracy in the early 1990s.

*Strengthen positive links between growth performance, labor markets and individual welfare.* The Chilean experience of the last two decades shows that rapid economic growth raises living standards and contributes to reduce poverty but the gains of enhanced prosperity are unevenly distributed. The labor market and the demographic characteristics of Chilean families are critical links between *aggregate* economic growth and *individual* incomes. In fact, poor families have larger size, higher dependency ratios, lower educational levels and a higher incidence of unemployment. Given these features the Chilean poor is bound to have benefited less from the prosperity of the last two decades than the non-poor. Low income families and the working poor are not well equipped to seize the opportunities opened by economic reforms as their skills may not match the demand for labor of higher skills and better education levels that accompany globalization and modernization. Furthermore, the poor often do not have access to capital and knowledge needed for business creation and integration to the international economy. For these reasons prosperity may fail to reach the poor in equal force than the accommodated middle class and entrepreneurial people with more education and contacts. In addition, poor workers are less protected when adverse shocks such as recessions and unemployment. Our analysis also shows that the poor often works in the informal sector of lower productivity and more job vulnerability. The informal sector operates in a dual way: both as a “buffer” that expands in bad times (recessions or periods of slower growth) and contracts in good times (periods of boom and rapid growth). In addition to this counter-cyclical role the informal sector is a structural feature of the labor and product market in growing economies that are unable to absorb productively the full labor supply.

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