Pensions and cities in Chile: short term misjudgements, long term cries

In Chile, as it might possibly have happened in many other countries trying to close per capita income gaps with respect to developed countries, there have been two silent but impressive changes within the last 20 years that will have deep impacts in our economy: the fall – to stay - in “risk free” real interest rates from levels close to 10% to less than 3% per year and a 5 year lengthening – with no end in sight - in life expectations that has occurred to its population. In other words, a dramatic improvement in costs (lower interest rate on physical and human capital) and productivity (slower depreciation in human capital) that will certainly have an upward and permanent effect in per capita incomes seldom known in our past, if public policies and the nation´s political and economic structure continue being on the right path, along competitive principles.

This lower and permanent cost of capital enables by itself, under efficiency conditions, far bigger needed investments (basically in infrastructure, in old and new cities and in other postponed areas now with competitive advantages under these new equilibrium conditions) which will strongly lift in the short term per capita capital stocks to developed countries standards, thereby resulting in higher per capita income levels after a transitional short period (a ten year capital adjustment period ?) is completed, keeping in mind that physical capital is easier to adjust than human capital.

On the other hand, having a human capital stock that all of a sudden is able to generate additional wealth for a longer period at a lower marginal cost could not be better news, even without taking into account how good it is and how fast it could be ameliorated, especially with respect to its educational levels, given existing good results in health standards – Chile has basically the same US life expectations, for example -.

The aggregate result of this silent growth process is to be reflected in the value of this country, if these opportunities are correctly undertaken. Relative to more developed countries that have already profited from this scenario, Chilean currency would gradually revalue on real terms until there is no relevant difference in the competitive structure of their economies and their marginal rates of return on capital are finally equalized. Of course, if Chile returns to old practices, it moves far away from the developed world, and its relative value would accordingly fall.

The previous facts constitute great news for the country as a whole, though not necessarily good news for those private or public agents that planned and took investment decisions under a different set of equilibrium values, which in the end result in costly miscalculations.

The pension fund area is one vivid example; another equivalent case is urban development.

Chilean pension funds amount to approximately US$ 74 billion in accumulated obligatory savings and pension related life insurance annuities liabilities are close to US$ 22 billion: US$ 96 billion (over 80% of US$ 115 billion GDP) are committed to periodic payments of retired persons, either through the gradual consumption of savings in pension funds accounts (defined contributions) or by taking annuities with life insurance companies (defined benefits). At present, there has been a serious questioning to the level of competition in this industry, which clearly reflects lack of foreign competition in our capital markets in general, but surprisingly there has not been a clear recognition that in the defined benefits area liabilities did in fact increase, either by not allowing its periodic payments discount rates to go conservatively down or by phasing out unanticipated longer life term expectations. In this last case, a capital increase at least equivalent to the existing one in the industry of life insurance companies (US$ 2,8 billion) is overdue. And as it should be obvious to any observer, a crack in the annuity system, which now pays out 60% of present pensions in the entire new private retirement system, would be tragic to the individual savings account principle. The lesson: from now on, retirement ages and annuities should be continuously redefined as life expectations change, and conservative real discount rates of future liability payments should be at most those of US Treasury inflation indexed long term bonds to which this country is converging, with an estimated average for the last 50 years of 2,5% per year.

In the case of our next revolution, that of our cities, lack of long term perspective was again the only real explanation for its lagging status. In essence, 85% of Chilean population today lives in cities, planned as if the country´s destiny was to have modest growths, with no need for modern transportation infrastructure and offering minimum urban services and crowded housing projects. Take Santiago, its capital (5,5 million inhabitants, 35% of Chilean population), as an example: a density four times that of greater New York and where at least 1/3 of its area will become obsolete in the next decade due to income growth that will make it undesirable to new middle income families. Once more, and continuing the example, we are here facing big cost figures: the value of Santiago´s land is now close to US$ 90 billion, not including investments over it that could easily be worth 5 times that amount, and any misstep involves huge wealth redistributions, and most probably, urban wealth destruction that could only be measured in tens of US$ billions, considering Santiago and the rest of our cities. After years of neglect, the solution is becoming clear: promotion of land competition while externalities, especially those of transportation, are to be internalized by new developments, along with housing vouchers “á la Katrina” and tollways inside cities. Big private and public housing and infrastructure projects, even recent ones, are to be redefined or simply replaced, due to this miscalculation. A more dynamic urban pattern, with higher incomes and an older and more demanding population, will emerge. Needless to say, this profound transformation process is more evident in the urban case than in others because of its massiveness and intensity in the use of capital, now at a lower interest rate that was not available years ago but that should have been expected, along with the evolution of per capita incomes.

At least, some of these problems arise because developing countries like Chile do grow. But most of them were avoidable, if only a significant group had really believed in the consequences of correct policies and its rewards. As usual, these changes did and do happen almost inadvertently, until they are evident to any casual bystander. Once again, the Invisible Hand at its plenitude –and silently -.

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