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Part IV

Three Liberalization Episodes

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Recent Liberalization Episodes

In section 1.4 the major features of three recent attempts at stabilization plus liberalization were outlined: the Ibañez-Klein program of 1956–58, the Alessandri program of 1959–61, and the Frei program of 1965–70. Details of each program were given in Part II of this book, and the impact of each on price-related measures was analyzed there. In Part III the consequences of the programs were explored for five major areas of macroeconomic policy.

In this final part, the three liberalization episodes are taken up again, with the focus of the analysis on four questions: Why were the liberalization efforts made? What was done? What were the short-run effects? Why did they fail?

Four major conclusions are drawn from this analysis.

i. The central objective in each case was not liberalization of the foreign sector. The change in the international economic regime was but part of an over-all stabilization effort. The primary objectives were to arrest inflation and end stagnation. The international economic situation was an important contributing factor, but less significant than the domestic issues.

ii. The limited degree of short-run success in regard to these and other concerns substantially weakened the foreign-sector liberalization attempts. Without such success, political momentum could not be maintained sufficiently long to reap the potential long-run advantages noted in Part III above.

iii. In all three efforts, even under the sliding-peg exchange-rate policy, the PLD-EER was kept substantially below equilibrium and was allowed to decline. The boom in the copper market in the late 1960s enabled the Frei government to follow such a NER policy without encountering major foreign-exchange shortages. The two earlier programs were not so successful in relation

to the world copper market. The attempt to maintain a below-equilibrium and declining price for foreign exchange, therefore, resulted in severe foreign-exchange shortages.

iv. A gradual approach to stabilization and liberalization has the advantage of not strongly disrupting the economic-political system. Some short-run successes may be scored in order to maintain momentum.

For Chile, the last point is highly pertinent. Given the failure of four major stabilization efforts and three major liberalization attempts in less than two decades, however, a gradual approach is not likely to be very credible there.¹ If it is not credible, changes will not occur to enable Chile to reap longer-run advantages. Instead, resources will be devoted to protecting vested interests from the transitory lessening of restrictions. Under such conditions it would be very hard to have enough short-run successes to maintain political momentum for a gradual approach even though long-run changes are not evident.

The best hope for gaining the long-run benefits from liberalization, therefore, may be by an abrupt transformation of policy.² The short-run costs may be large (and may be mitigated in part by appropriate policies). But only such an attempt may make the whole effort credible and thus change expectations sufficiently quickly so that the long-run advantages begin to appear before all political momentum is lost.

13.1 MOTIVATIONS FOR LIBERALIZATION EFFORTS

Both external and internal factors entered into the decisions to initiate liberalization programs. Table 13.1 includes some indicators of these factors for the year immediately preceding each program as well as for its first and last year of operation.

13.1.1 External Factors.

Three aspects of the external situation are of primary interest: the role of pressure from the IMF and from donor and creditor countries; the extent to which the immediate foreign-exchange position was unusually precarious; and the significance of perceptions of inefficiencies due to foreign-sector policies.

IMF PRESSURE.

The IMF in particular repeatedly has advocated reform and liberalization of Chilean international economic regimes. The policies prescribed by the IMF comprise what is known as the "monetarist" position in the "structuralist-

TABLE 13.1
Selected Indicators of External and Internal Chilean Economic Conditions in Years Preceding
Liberalization Attempts and in First and Last Years of Liberalization Episodes, 1955-70

| | Ibañez Period | | Alessandri Period | | | Frei Period | |
|--|------------------|-------------|----------------------|-------------|-------------|----------------|-------------|
| | 1955 (1) | 1956 (2) | 1958 (3) | 1959 (4) | 1961 (5) | 1964 (6) | 1970 (8) |
| External | | | | | | | |
| 1. PLD-EER for goods imports | 2.90 | 3.62 | 4.37 | 4.61 | 4.02 | 3.65 | 3.85 |
| 2. PLD-EER transactions ratio: nongoods to goods | 2.53 | 1.27 | 1.30 | 0.85 | 0.81 | 1.17 | 1.01 |
| 3. NER ratio: black market to national accounts | 3.12 | 1.50 | 1.54 | 1.01 | 1.01 | 1.96 | 1.65 |
| 4. Ratio of high to low sectoral PLD-EER (PI)s | 12.43 | 8.06 | 3.97 | 4.06 | 3.55 | 4.02 | 3.51 |
| 5. PLD-EER (PI) ratio: imports to exports | 1.35 | 1.34 | 1.90 | 1.71 | 1.67 | 1.65 | 1.47 |
| 6. Average import premium rate | 2.04 | 1.32 | 0.64 | 0.51 | 0.62 | 0.69 | 0.57 |
| 7. Ratios of Chilean trade statistics to those of major trading partners | | | | | | | |
| 7.1 Imports recorded by Chile to exports recorded by others | 1.44 | 1.05 | 1.36 | 1.35 | 1.06 | 1.27 | 0.98 |
| 7.2 Exports recorded by Chile to imports recorded by others | 0.99 | 1.02 | 0.96 | 0.96 | 0.95 | 0.92 | 0.90 |
| 8. Net balance of payments (mill. 1958 dol.) | 27.0 | -25.9 | -107.1 | -42.2 | -288.6 | -131.4 | -46.9 |
| 8.1 Goods and services | -0.8 | 21.8 | 34.3 | 42.6 | 163.4 | 135.0 | 81.2 |
| 8.2 Ratio: capital to nonmonetary sectors | -35.0 | 2.6 | 22.3 | -28.2 | 124.5 | -20.2 | -49.6 |
| 8.3 Ratio: capital and gold to monetary sectors | | | | | | | |
| 9. Net foreign reserves held by banking system (mill. dol.) | 100.6 | 88.6 | -13.4 | 12.0 | -164.8 | -238.7 | -182.9 |
| Internal | | | | | | | |
| 10. Rate of change of GDP deflator (per cent) | 75.6 | 58.3 | 26.2 | 40.6 | 7.9 | 47.2 | 28.2 |
| 11. Capacity utilization rate for GDP | 0.89 | 0.88 | 0.91 | 0.90 | 0.93 | 0.90 | 0.93 |
| 12. Ratio: government deficit to GDP | 0.02 | 0.02 | 0.03 | 0.03 | 0.04 | 0.04 | 0.04 |
| 13. Average wage/consumption deflator (1965 = 1.0) | 0.74 | 0.78 | 0.80 | 0.72 | 0.84 | 0.96 | 1.00 |
| 14. Wage share of GDP | 0.63 | 0.66 | 0.63 | 0.57 | 0.63 | 0.65 | 0.65 |
| 15. Rate of growth of real GDP per capita | -1.1 | -1.3 | 0.2 | -2.0 | 0.8 | 0.4 | 4.8 |

SOURCE: Lines 1, 2, and 6 are from Table 5.1. Lines 3, 4, and 5 are from Table 5.2. The source for lines 8.1-8.3 is the same as for Table 8.1. The sources for all the other data are given in Table A.1. The series and means in the earlier tables provide points of comparison for the annual observations here.

monetarist" debate referred to a number of times above. Pinto [1960] and others have criticized the 1956-58 attempt because they claim it followed the IMF prescription, with the result being "neither stability, nor development."

Pressure from the IMF and donor and creditor countries apparently was considerable in the mid-1950s. For the 1952-55 subphase net capital inflows to the central government and net IMF credit both dropped substantially in comparison with the previous subphase (lines 13 and 15.1 in Table 8.1). Before the 1965-70 attempt, significant pressures, at least implicitly, were applied from abroad because Chile sought foreign cooperation in the debt rescheduling of 1965. The decline in the net credit from the IMF in the years immediately before the Frei liberalization also may indicate more direct pressure (line 15.1 in Table 8.1).

For the first and, to a smaller extent, the third liberalization episodes, therefore, outside official pressure provided an impetus for liberalization. Before the second attempt, there is no evidence of unusual foreign pressure, nor of a decline in net inflows from official sources (lines 13 and 15.1 in Table 8.1). Even before the third effort, moreover, a large increase in the net inflow to the government much more than offset the above-mentioned fall in IMF credit. Thus, the importance of foreign official pressure in the initiation of these liberalization attempts should not be overemphasized.

It should be pointed out, nevertheless, that the identification of the 1956-58 attempt in particular with foreign interests discredited this program in the eyes of many Chileans. In part the identification was with official foreign agencies, especially the IMF. Much more of this identification, however, was associated with Klein-Saks, a Washington-based private consulting firm hired by the Ibañez government. Hirschman [1963] claims that the presence of the Klein-Saks mission probably facilitated the rapid acceptance of policies largely suggested previously by the Central Bank and former ministers of finance Felipe Herrera and Jorge Pratt. He also maintains, however, that the intermediary role employed by this mission enabled the major political groups in Chile to avoid direct confrontation over the basic issues. Fundamental problems were covered up, but not resolved. Subsequent criticisms of the over-all program, moreover, have been directed in large part toward Klein-Saks. The net result has been an overemphasis on the role this mission actually played, and further avoidance of the basic underlying issues.³

FOREIGN-EXCHANGE SHORTAGES.

Before the second and third attempts, the immediate foreign-exchange shortages were severe. The deficits on current account were quite large, and net foreign reserves were very low (columns 3 and 6 for lines 8.1 and 9 in Table 13.1). Capital flight through overinvoicing of imports apparently was extensive (line 7.1 in Table 13.1). In the third case, moreover, the previously

noted large debt repayment obligations added further claims on the limited supply of foreign exchange. For both of these efforts, therefore, a substantial immediate foreign-exchange crisis added to the pressure for a change in the international economic regime.

Before the first attempt, in contrast, the role of an immediate foreign-exchange crisis was much less. True, substantial capital flight was occurring (column 1 for lines 3 and 7.1 in Table 13.1). But the surplus on current account actually was quite large and net foreign reserves were relatively high (lines 8.1 and 9).

In the third episode, moreover, the immediate reaction to the initial foreign-exchange crisis included some increase in restrictions, e.g., the import application rejection procedure of 1965 described in subsection 4.1.2. In that case, in fact, foreign-sector liberalization accelerated over the phase. One factor in this intensification was the concentration of the efforts of a number of talented individuals in the Central Bank on reforming the foreign sector after hopes for the reforms in other areas had been frustrated. Of very substantial importance, however, was the improvement in Chile's foreign-exchange position over the phase, which was largely due to the booming international copper market.

Thus, immediate foreign-exchange crises were a motivating factor in the second and third liberalization efforts, but not in the first. Once the liberalization program commenced, subsequent intraphase changes generally reflected a direct rather than an inverse association between liberalization and the availability of foreign exchange.

INEFFICIENCIES OF FOREIGN-SECTOR POLICIES.

Many of the distortions and income effects of restrictive Chilean international economic regimes are analyzed in Chapters 5, 10, and 11. Although it is very difficult to specify the exact importance of the regimes, apparently the perception of a number of their negative effects on certain areas of the economy partially underlay the desire for liberalization among an important group of Chilean technicians and businessmen. Specific perceived shortcomings included extreme instability, large windfall gains, corruption, disincentives for investment and for exports, whose foreign-exchange proceeds paid for imported investment goods, inefficient resource allocation, preferences in import quotas granted to large firms, overdependence on imported inputs, delays, arbitrariness of operation, and large personal economic rewards—not for increasing productivity, but for obtaining better NERs, larger quotas, or correctly anticipating massive devaluations.

13.1.2 Internal Factors.

The external situation had some importance in the motivation for each of the three liberalization episodes. Of much greater significance, however, was the internal situation, two of its characteristics in particular:

i. In all three cases liberalization of the foreign sector was *not* the dominant goal in itself. Instead it was but one component of an over-all stabilization program. The primary motives were to reduce inflation and to increase capacity utilization. In the year immediately preceding the commencement of each of the efforts the rates of inflation were, respectively, 76, 26, and 47 per cent (line 10 in Table 13.1). In each case inflation was accelerating.⁴ Capacity-utilization rates also were low, although less so in the second case (line 11 in Table 13.1). These internal concerns predominated among the motives for the three efforts.

ii. In an immediate sense, all three efforts also were the result of new programs that followed substantial political shifts.⁵ In the first case, the internal political and economic conditions had deteriorated so much that complete breakdown of the political and economic systems seemed imminent. That threat induced the formation of an informal coalition among Ibañistas, Conservatives, and Liberals with the help and guidance of the new finance minister, Oscar Herrera (not to be confused with Felipe Herrera, mentioned earlier), and the Klein-Saks mission. This new grouping broke a long-existing parliamentary stalemate and legislated the 1956-58 program of stabilization with liberalization.

In the other two cases the nature of the political shift was more obvious. Presidential elections caused changes in the government. In late 1958 Alessandri won the election, and in late 1964 Frei was elected to succeed him. In both cases the new governments, counting somewhat on their initial political momentum, soon tried to initiate major programs of stabilization with liberalization.

At times discussions of liberalization of the foreign sector are written as if all internal motives and policies were but adjuncts to the primary concern with the international sector. Such a view does not reflect the reality of the Chilean political economy. The basic causes of liberalization efforts generally have been internal factors. Foreign repayment obligations, speculation against the currency, capital flight, and donor- and creditor-country pressures have all been significant, but less important than internal concerns. Foreign-sector policy generally has been much more an appendage of domestic policy, albeit an important appendage, rather than vice versa.

13.2 WHAT WAS DONE

Details of the changes in the components of the international economic regime included in the liberalization packages were given in Chapters 3 and 4. Here four major characteristics of the programs are summarized: the net or effective devaluation, the changes in import premiums and in EERs for the different categories, related monetary and fiscal policies, and the size and impact of official foreign credits.

13.2.1 Net Devaluations.

The liberalization packages all included substantial initial nominal devaluations. In the first year the weighted average of all NERs changed, respectively, by 94, 47, and 34 per cent (line 13 in Table A.7). Prima facie, these appear to be large devaluations. However, two factors are not taken account of in these figures. First, given the extent and duration of the Chilean inflation, some deflation of the NERs is necessary. In the first year of each episode, the respective changes in the PLD-NERs were only 22.5, 4.3, and 4.4 per cent (column 13 in Table 3.2). Second, at the same time that the nominal devaluations occurred, other changes were being made in the international economic regime. The net impact of these other changes was to lessen price and quantitative trade barriers. The PLD-EERs changed by 24.8, 5.5, and 5.5 per cent (column 1 in Table 5.1 or line 1 in Table 13.1). Therefore, the initial net devaluations were somewhat larger than an examination of PLD-NERs alone would indicate, but much smaller than examination of NERs or EERs alone would suggest.

After the first year, the patterns of changes in the PLD-EERs varied substantially in the three liberalization attempts (column 1 in Table 5.1). In the first episode, the weighted average rose 35 per cent in the second year, but fell 11 per cent in the third year. In the second attempt a constant NER was maintained as a symbol of price stability. Therefore, the PLD-EER dropped 7.6 and 5.6 per cent, respectively, in the second and third years. In the third program a sliding-peg NER policy was adopted. Nevertheless, the PLD-EER fell in four of the five subsequent years of the program by from 1.9 to 4.9 per cent. The exception was a 3.0 per cent rise in 1968. The general tendency, therefore, was for the PLD-EER to decline after the initial large devaluation. In only two of the nine relevant years did it increase instead.

In all three cases, however, the really major problem with NER policy was not the tendency to let PLD-EERs decline during the phase. The major problem was that initial devaluations were not sufficient to achieve equilibrium (see Bacha and Taylor [1973:144] and line 1.1.1 in Table A.1 for two indices

of the extent of disequilibrium). The tendency for the PLD-EERs to fall only exacerbated the situation. Given the responses of various items in the balance of payments (see sections 6.2 and 7.2 and Chapter 8), the continued maintenance of below-equilibrium PLD-EERs guaranteed an eventual foreign-exchange crisis or pressure to increase trade barriers in order to avert such a crisis.

13.2.2 Changes in Import Premiums and in Discrepancies in Effective Exchange Rates.

The import premium rate fell substantially in the first year of the three liberalizations—by 34, 20, and 17 per cent respectively (column 6 in Table 13.1 or column 4 in Table 5.1). There was a considerable immediate shift in income per unit of imports, therefore, from the former recipients of import privileges. During both the first and the third episodes, moreover, further declines were recorded. In a few years, these subsequent decreases were quite large—51 per cent in 1957 and 17 per cent in 1968 (although increases of 9 per cent in the next two years partially offset the latter). During the second effort, however, the premium increased 24 per cent after the first year with the result that in the last year it was not significantly less than before the commencement of that phase.

As is indicated by the data in Table 13.1, lines 2, 3, 4, and 5; Table 5.1, column 3; and Table 5.2, columns 1 and 6, discrepancies among the EERs for different categories of transactions also generally fell significantly with the initiation of liberalization compared to the year preceding the effort. Quite generally, therefore, distortions and differential incentives were cut—often substantially—by the initiation of the liberalization efforts, with one important exception, however, which was pointed out in subsection 5.1.2: discrimination against agriculture increased in two of the cases and remained the same in the third because the government tried to damp inflationary expectations by keeping the rate of increase of food prices down.

After the first year of liberalization, many of these discrepancies widened again. In 1956–58 this was true for the nonmerchandise-to-merchandise ratio, the black-market to national accounts NERs, and (most strongly) the imports-to-exports ratio. In 1959–61 differences grew for the nonmerchandise-to-merchandise ratio. In 1965–70 the same occurred for the first two indices but not for the imports-to-exports ratio. As the liberalizations lost their initial momentum, therefore, differential incentives and distortions commonly grew, especially in the two cases in which the import premium rate tended to fall.

13.2.3 Related Fiscal and Monetary Policies.

As is emphasized in section 13.1, fiscal and monetary policies were not basically subsidiary components of the foreign-sector liberalization programs. To the contrary, the liberalization of the foreign sector was but one aspect of the over-all stabilization effort. The major concern of the government in all three stabilization episodes was to reduce inflationary pressures. In 1956–58 restrictive monetary policy reduced the rate of growth of the money supply from 62 per cent in 1955 to 44, 35, and 28 per cent respectively in each of the next three years. In the first year of the next effort, 1959–61, it increased somewhat to 30 per cent, but thereafter fell to 23 and then to 26 per cent. In the first year of the 1965–70 phase it increased to 54 per cent (as compared to 40 per cent in 1964). In the next two years it declined to 46 and then to 22 per cent respectively, but thereafter increased to 36 per cent in 1968, to 42 per cent in 1969, and to 66 per cent in 1970. Except in the first attempt, then, monetary policy was initially not all that restrictive. In the last two efforts it subsequently became tighter, but then loosened near the end of each phase.

In all three stabilization programs the government announced its intention to reduce the size of the government deficit (line 12 in Table 13.1). In the first year of the Ibañez-Klein-Saks program a cut of 15 per cent in real terms was achieved. In the next two years and continuing through the Alessandri program, however, the size of the real government deficit increased steadily, with annual increases of 53, 14, 26, 29, and 1 per cent. These governments were able neither to reduce expenditures significantly nor to reform the tax system to make it more effective.

In the first year of the Frei period, once again the real government deficit increased—this time by 18 per cent. Thereafter, however, it fell to a much lower level. It dropped 23 per cent in 1966 and another 45 per cent in 1967, and fluctuated around the resulting new lower levels for the rest of the phase. The reasons for this change are twofold: the Frei government was much more successful than its predecessors in implementing some effective internal tax reforms; and the copper boom greatly increased real revenues from mining and exports, in part because of the relatively high degree of participation of the Chilean government in the returns (see subsection 4.2.1).

Not only the size of the government deficit is important. If aggregate demand has a role in the determination of output, the level of government expenditure for a given deficit also is significant. In the first year of the Ibañez-Klein-Saks program real government current expenditures were cut 3.7 per cent as part of the stabilization effort. In the last two years of that program and in all three years of the Alessandri effort expenditures increased (by 6.7, 11.1, 1.6, 6.1, and 1.4 per cent, respectively). They rose 16.6 per cent in the first

year of the Frei phase and 8.6 per cent in the second. In the third year they declined imperceptibly, and thereafter increased at moderate rates.

Except for the first year of the 1956-58 phase and the last two years of the Frei program, thus, fiscal policy was fairly expansionary during the three stabilization-liberalization episodes. The maintenance of expansionary policies in the midst of anti-inflationary programs was due to difficulties in obtaining and implementing fiscal reforms on the one hand and to the desire to limit recessions on the other.

The over-all impact of monetary, fiscal, and other policies on inflation had the same general pattern in each of the three episodes (line 10 in Table 13.1 and line 2.1 in Table A.1). The annual rate of change of the GDP deflator dropped substantially in the initial stages of the program. As political momentum tailed off, however, discipline faltered and inflationary pressures once again grew.

The total impact of such policies on capacity utilization and growth differed somewhat in the three episodes (lines 11 and 15 in Table 13.1 and lines 2.2 and 5.1 in Table A.1). The first two programs were characterized by an initial drop in both capacity utilization and over-all growth, followed by an increase and then a decline as the effort fizzled out. The Frei period had high capacity-utilization rates and growth in the first two years (e.g., per capita GDP increased by 4.8 and 9.0 per cent respectively in 1965 and 1966), followed by relative stagnation.

13.2.4 Size and Impact of Official Foreign Credits.

Average annual net inflows to the central government and central institutions in millions of 1958 dollars increased from 2.3 in 1952-55 to 16.7 in 1956-58 and to 52.6 in 1959-61 (line 13 plus line 15 in Table 8.1). In the first two liberalizations the increased supplies from imports made possible by these larger net inflows aided substantially in the reduction of inflationary pressures. These increases did not occur, however, in the first year of these programs. Instead, they were recorded in the second and third years as the government attempted to salvage the effort by using enlarged foreign debt to provide purchasing power. When additional foreign credits became difficult to obtain—especially in late 1961—the programs collapsed.

For the Frei attempt the pattern was reversed. The net inflow in millions of 1958 dollars increased from 81.8 in 1964 to 135.3 in 1965, but the average annual level declined from 106.9 in 1962-64 to 64.3 in 1965-69. As is noted in section 8.2, the drop in the mean inflow primarily reflected a drop in foreign-exchange needs because of enlarged revenues generated by the copper boom of the late 1960s.

In all three cases, then, net inflows of official foreign credits played im-

portant short-run roles. In the first two programs they allowed the liberalization efforts to be prolonged. In the third they helped it to get started. In no case, however, did they lead to long-run success. In the long run, in fact, they may have been dysfunctional by obscuring the fact that the exchange rate remained well below equilibrium.

13.3 SHORT-RUN EFFECTS OF LIBERALIZATION

The long-run advantages of liberalization as they relate to four areas of Chilean macroeconomic policy—foreign-exchange position, resource allocation, income distribution, and development—were taken up in earlier chapters. But whether or not a liberalization prevails long enough for those advantages to be realized depends in considerable part on the short-run impact of those policies. Consequently, the latter question, also, has been taken up in detail, and the issues are summarized in this section.

13.3.1 Foreign-Exchange Position.

A wide variety of responses of components of the balance of payments to liberalization and devaluation are detailed in chapters 6, 7, and 8. Speculative inventory holding and capital flight fell. Extralegal flows declined. Exports, especially of a nontraditional nature, and net direct investment inflows increased. Desired imports tended to drop due to higher PLD-EERs, but actual imports tended to rise significantly because there were fewer quantitative restrictions. (The latter situation particularly characterized capital goods imports.)

On a general-equilibrium level many substantial partial-equilibrium direct responses were largely offset by indirect effects, especially those transmitted through the nexus of foreign exchange, money, and prices. The general-equilibrium response to a devaluation alone, therefore, was not large. Moreover, since devaluation was not sufficient to reach equilibrium levels and since the PLD-EERS tended to decline during the more liberal phases, pressure on foreign exchange was increased. In addition, the import responses to reduced quantitative restrictions were substantial.

The net result of all of these factors included rather substantial deficits on current account in all three attempts (line 8.1 in Table 13.1 and line A in Table 8.1). In the first two efforts the mean annual deficit in constant dollars rose significantly over that for the previous phase. In all three cases these deficits tended to increase during the phase—in part because of the declining PLD-EERs for imports (line 1 in Table 13.1 or column 1 in Table 5.1).⁶ In-

creasing differentials between the PLD-EERs for imports and for exports exacerbated the problem in the 1956-58 and 1959-61 phases (line 5 in Table 13.1).

The pressure on foreign exchange, therefore, was great and growing. In 1965-70 the copper boom and the large net capital inflows relieved this pressure. In the earlier attempts the net official inflows provided transitory relief (see subsection 13.2.4). When funds from these sources became less readily available or dried up, the government had to alter the international economic regimes. It chose to abandon the liberalization attempt, gradually in the first case and quite abruptly in the second. In neither case did it first increase the PLD-EER for imports or reduce the discrimination against exports. In 1958 the Ibañez government did not consider such alternatives because the whole political situation had so disintegrated that only piecemeal, ad hoc measures could be applied. In 1961 the Alessandri government did not pursue them because a fixed NER was an important symbol, if not the cornerstone, of the price stabilization effort.

13.3.2 Cyclical Fluctuations in Nominal and Real Terms.

Within a general-equilibrium context, devaluation alone led to substantial immediate inflationary pressure. This part of the stabilization-liberalization package thus worked strongly against initial price stability. Reduction in quantitative restrictions, however, had the opposite effect. As long as sufficient foreign exchange was available to finance increased imports, reductions in restrictions led to increased supplies and lower inflationary pressure.

In the 1959-61 program, this method was used to reduce inflation to the lowest level since the Second World War. The GDP deflator increased only 9.5 per cent in 1960 and 7.9 per cent in 1961. A fixed NER, as is noted above, also was utilized as a symbol of stability in order to damp inflationary expectations. Shortly after the foreign-exchange crisis of late 1961, quantitative restrictions were intensified and the fixed NER was abandoned. Inflation accelerated rapidly.

The short-run impact of both devaluation and liberalization on output was negative. Increased competition from imports more than offset the greater availability of imported inputs. This effect could have been lessened by lowering trade barriers immediately on noncompetitive imports and only more slowly on competitive imports. To do so, however, would have left many inefficient industries with even greater effective protection. It also might have made the whole liberalization attempt seem less credible.

Another possibility would have been to use fiscal and monetary policy to offset the contractionary impetus of liberalization. This was done in 1965 and 1966. The obvious problem is that such a strategy increases inflationary pres-

asures. In the Frei program the government tried to increase capacity utilization and growth by expansionary fiscal and monetary policy limited by a programmed decline in the rate of inflation. The latter, it was hoped, would reduce inflationary expectations despite the booming economy. There was initial success, but momentum could not be maintained for more than a year or two. Thereafter, both inflation and stagnation again became more troublesome.

13.3.3 Resource Allocation and Structural Change.

The effect of liberalization on resource allocation among sectors and subsectors is detailed in Chapter 10. Agriculture and the more modern and intermediate-goods-oriented manufacturing subsectors were particularly responsive to liberalizations. Mining also responded positively. The more traditional and consumer-oriented manufacturing subsectors, in contrast, generally were unable to meet the increased competition of the liberalized flow of imports.

The pattern of response poses a dilemma for the government. On the one hand, the short- and medium-run costs of diverting resources from some of the long-protected traditional industries are quite high. These costs are not only economic but political as well, because some of these subsectors have acquired considerable political power. On the other hand, in the absence of foreign competition the same industries have shown little tendency to become efficient. Continued protection apparently would entail incurring a number of the costs described earlier without promoting substantial development. Moreover, it would further reinforce those who already have vested interests in a restrictive system.

Perhaps some gradual reduction in protection with interim aid in reallocating resources would provide a solution. Given past experience, however, any proposal for gradual adjustment might not be credible. Rather than cooperate, the affected industries might see their own interests to be in intensive lobbying for reinstatement of high EPRs.

13.3.4 Distribution of Control over Income and Resources.

As detailed in Chapter 11, the consequences of liberalization for the various elements of control over income and resources have been complex and often dependent upon the time period under consideration. In the short run, liberalization and devaluation had a negative impact on the income going to labor,⁷ traders who received the import premium, the owners of factors in heavily protected industrial subsectors, the bureaucrats who ran the system, and domestic, as opposed to foreign, factor owners. The effect on the split between public and private control over resources depended on the relative

weight of devaluation versus a reduction in restrictions, with the government being favored the more there were reductions in restrictions.

Some very strong or very important groups, thus, were adversely affected in the short run by liberalization. One can always conceive of partial liberalizations or subsidies which would mitigate these effects. Too much emphasis on the former would hamstring the whole effort. Adoption of explicit subsidies would lessen distortions and make the transfers more explicit and, it would be hoped, more responsive to the general political will. Given the problems in fiscal reforms, however, subsidies, also, involve significant costs.

13.3.5 Economic Growth.

The impact of liberalizations on economic growth is detailed in Chapter 12. In the short run, of course, there was very little effect on the over-all capacity of the economy. Because of induced changes in capacity utilization, however, measured real GDP per capita changed. That it declined by -1.3 and -2.0 per cent, respectively, in the first year of the first two stabilization-liberalization programs caused critics to cry out in alarm (line 15 in Table 13.1). At the start of the Frei program, therefore, the government followed more expansionary policies to avoid the same outcome. The effort was rewarded by a growth rate of real per capita GDP of 4.8 per cent in 1965, followed by a rate almost twice as high in 1966.

13.4 WHY LIBERALIZATION FAILED

All three of the liberalization efforts failed. The same general factors underlay the lack of success, but with different relative weights in different episodes.

The end of the Ibañez-Klein-Saks effort formally was signaled by the presidential election of late 1958. Effectively, however, this program had faltered long before the election. The basic problem was a lack of sufficient short-run success in the over-all stabilization program to allow the maintenance of political momentum. Inflation had been reduced significantly, but still was quite high and was accelerating again in 1958. Significant positive growth in real per capita income had been obtained only in one year of the program, and the growth rate was declining in 1958. Parliament refused to pass basic tax reform legislation. Rumors of graft and corruption increased, especially regarding the operation of the special regime in the department of Arica. Students demonstrating against increases in bus fares clashed with troops, and 18 deaths and over 500 injuries resulted in April 1957. In the same year, a poor harvest

caused relatively rapid increases in food prices. Government fiscal-deficit problems were not solved. By the time of the 1958 departure of Klein-Saks, the government had lost control of the situation.

The failure of foreign-sector liberalization accompanied the failure of stabilization. The foreign-sector situation was exacerbated, moreover, by growing foreign-exchange shortages. These shortages, in turn, partially originated in excess demand due to the falling PLD-EER. Government reluctance after mid-1957 to keep up with the internal inflation had its toll. The drop in the world price of copper after 1956 further aggravated the foreign-exchange shortage.

The end of the Alessandri liberalization also reflected insufficient short-run success. The rate of increase in the GDP deflator had fallen to the lowest level since the end of the Second World War, but the average rate of growth of real product also had dropped to the lowest level since 1955. Despite some success in fiscal reform, the government deficit increased to all-time highs.

In an immediate sense, however, the termination of this phase was almost entirely due to a balance-of-payments crisis. Foreign-exchange reserves and the national foreign credit standing were exhausted because of failure to control the government deficit and because a substantially overvalued NER, with its overvaluation steadily increasing, was being maintained side by side with a liberal trade regime. The public-sector debt in foreign currency had increased 101 per cent to a level of \$788 million by the end of the phase. Total Chilean debt in foreign currency (not including direct private credits or deferred payment import credits for which data are unavailable) increased 81.7 per cent to a level of \$954 million, equal to 183 per cent of exports or 22 per cent of GDP (at the official exchange rate) in 1961. Net international reserves held by the banking system plummeted to a new low of -\$164 million at the end of 1961. In December 1961 the Central Bank liquid reserves were down to the equivalent of approximately ten days of imports. A considerable number of import applications were still pending. The Central Bank could not borrow further from abroad because of the substantial foreign debt. On December 27, 1961, the Central Bank revoked all authority to deal in foreign exchange and established prohibitive 10,000 per cent prior deposits on all imports. Thus, the Phase IV period and the internal stabilization program ended.⁸

The Frei government had the advantage of hindsight about the two previous failures. Therefore, it adopted a strategy with two major components: a programmed decline in the inflation rate over several years so that inflationary expectations could be lowered but a recession averted and a sliding-peg NER policy in which the PLD-EER would be increased over time to its equilibrium value.

In 1965 and 1966 success was fairly general. Inflation was cut signifi-

cantly, and growth was quite high. The PLD-EER declined, however, despite the intent of the sliding-peg policy.

In 1967 considerable internal political cohesion was dissipated in an abortive attempt to introduce a compulsory savings plan for 1968 wage increases exceeding 10 per cent and to suspend the right to strike. In reaction to these proposals a general strike was called in December 1967, the political parties of the left coalesced against the government, and political support from the right also declined in opposition to the features of the program which would limit the freedom of business and in opposition to other government programs such as agrarian reform. Several ministers of finance resigned in succession, and the government proposal was defeated after months of acrimonious debate. With that failure, stabilization efforts faltered considerably. In this instance, however, foreign-sector liberalization was not abandoned. If anything, it was intensified.⁹ The reasons for this were twofold. (i) The copper boom of the late 1960s led to an immediate relaxation of the foreign-exchange constraint. Because of this boom the mean United States producer price for copper exceeded that in the previous phase by 39 per cent, the mean IME copper price exceeded that in the previous phase by 77 per cent, and the Chilean terms of trade improved substantially. (ii) A number of skilled Chilean economists in the government, once their efforts at internal reform had petered out, turned their attention to reforming the international economic regime.

Despite the expanded emphasis on liberalization of the foreign sector, the PLD-EER was very low and declining (except for a slight rise in 1968). Nevertheless, revenues from copper were sufficient to avert an immediate foreign-exchange crisis.¹⁰ This phase was brought to an end, instead, by the election of the Allende government in late 1970. The earlier failure of stabilization, of course, probably was an important factor in the election outcome.

Thus, Chile has had at least one abrupt stabilization-liberalization effort which failed because the short-run success of the effort was insufficient to maintain political momentum. It also has had one gradual attempt which failed in part because the short-run success could not be maintained for a long enough time to generate stability. It has always attempted to liberalize with a below-equilibrium and often declining PLD-EER.

To increase the probability of reaping the long-run benefits of successful liberalization, one obvious prescription is to draw the PLD-EER much closer to its equilibrium level and prevent it from declining under the pressure of inflation. When sufficient political momentum exists to attempt another liberalization, moreover, an abrupt change would seem preferable to a more gradual one. The sudden alteration would have short-run costs, some of which could be mitigated by transitory subsidies. But it might make it possible to change underlying expectations before political momentum was lost, so that some of the longer-run benefits would begin to appear. Given three liberalization and

four stabilization failures in less than two decades, cynicism about the probability of success of any gradual attempt is liable to kill it before longer-run benefits appear.

NOTES

1. This point is not in conflict with the second point above. The latter refers to past efforts, while this one refers to any future attempts, given the past failures.

2. As is discussed in Chapter 12 and other segments of Part III, however, the empirical foundation which the Chilean experience provides for expectations of large long-run benefits is weak. To argue strongly for these long-run benefits one must rely on analogies with the experience of other countries, such as Brazil.

3. The existence of foreign scapegoats, in other words, allowed a superficial consensus without a basic agreement on the sacrifices required of the type which Sturc [1967:216] has emphasized.

4. The 1958 rate of inflation was below that for 1957, but it accelerated during 1958.

5. It is always possible to ask whether or not economic conditions caused the political shifts. In fact, their contribution seems to have been considerable. But in an immediate sense these political changes were important in themselves.

6. The PLD-EER for 1958 exceeded that for 1956. but was less than that for 1957.

7. The wage share of GDP rose in the first year of the Ibañez-Klein-Saks program, but fell during the phase. It fell substantially in the first year of the Alessandri effort and recovered only partially during the phase. It remained the same in the first year of the Frei episode and increased slowly thereafter (line 14 in Table 13.1). This share, of course, was affected by all policies—not only foreign-sector ones.

8. Although anticipated in some quarters, these events were not foreseen by all observers. For example, apparently late in 1961 Hirschman [1963:220] approved the appointment of Luis Escobar (a representative of the structuralist school who had been dean of the Faculty of Economics at the University of Chile) as Minister of Economics in August 1961. He also noted that the government had a majority in both houses and had the assurance of long-run assistance from the Alliance for Progress. He concluded: "Hence, the chances for improving the performance of the Chilean economy in various structural ways while keeping the traditional scourge [i.e., inflation] under control looked more promising than they had for a long time."

9. Rather extensive plans to further liberalize the tariff and the whole trade system in order to encourage more domestic efficiency were later discussed in Banco Central [1970b:463-467], but because of the subsequent political events these plans were never carried out.

10. At the end of this phase the banking system had the highest level of net international reserves in more than two decades. At the same time, the foreign debt totaled close to \$3 billion. As a proportion of annual export value it had fallen somewhat to 248 per cent. Relative to GDP it had dropped to 27.2 per cent. Nevertheless, these debt obligations remained very large and constrained the new Allende government.

