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Short-Run Stability in Nominal and Real Terms

In the previous three chapters an examination was made of the impact of Chilean international economic regimes on her balance of payments. In the remainder of Part III, the effects in other major areas of concern of macroeconomic policy are explored. This chapter is focused on short-run stability. Short-run fluctuations are of considerable importance because they frequently have undermined Chilean attempts to liberalize, to transform the structure of the economy, to redistribute economic power, and to develop more rapidly. Price stability is taken up in section 9.1, and variations in real output and in the utilization of primary factors are explored in section 9.2.

SUMMARY AND CONCLUSIONS

i. Prima facie, inflation rates seem to have been inversely related to the degree of liberalization. Such an association does not reflect causality. Instead it reflects the fact that the liberalization efforts were part of the briefly successful stabilization programs.

ii. At times, inflation may have been imported from abroad owing to price increases in world markets. On the average, however, Chilean price increases have far outpaced those in the relevant world markets.

iii. The impact of devaluation and liberalization on prices is quite complex because of many simultaneous indirect effects, especially through the nexus of monetary system, prices, wages and anticipated inflation. Devaluation alone leads to fairly considerable short-run price increases: the impact elas-

ticity of price with respect to the NER is 0.6. This result in isolation validates a widespread Chilean fear of the inflationary effect of devaluation.

Reductions in quantitative restrictions, however, work in the opposite direction. This last fact has often been ignored in discussions of the inflationary impact of liberalization and devaluation. Such a policy package, therefore, would be less inflationary than is often hypothesized.

iv. *Prima facie*, short-run fluctuations in capacity utilization do not seem to have been related to the degree of liberalization. This lack of association is not surprising given the importance of domestic factors in determining output and given that many of the important foreign-sector factors have been beyond Chilean control and thus not affected by her international economic regime.

However, Chilean policies have exacerbated the sensitivity of her capacity utilization to international market fluctuations beyond her control by discouraging risk reduction through diversification of exports and by increasing the probability of balance-of-payments crises with their attendant shortages of imported inputs through negative inducements for exports and positive ones for imports.

v. The short-run impact of devaluation and liberalization on output is negative. Reduced quantitative restrictions lower output immediately through increased competition more than they increase it by higher imports of intermediate inputs. These results reinforce the frequent Chilean pessimism about the short-run real impact of liberalization and devaluation. They contrast sharply, moreover, with the Taylor and Black [1973] estimate of an employment elasticity with respect to devaluation of 0.9. The Taylor and Black result appears to be misleading because of the assumed exogenism of nominal wages, the money supply, and anticipated inflation.

vi. The instruments at the Chilean government's disposal for improving the trade-off between unused capacity and inflation are limited indeed. Monetary policy has exogenous elements, but the monetary base and the monetary multiplier both respond substantially to foreign-sector changes. The development of more effective monetary tools would increase the possibility of avoiding some of the negative short-run effects of devaluation. However, the trade-off would remain unless there was a fairly substantial drop in inflationary expectations. Because of the long history of inflation in Chile, inducing such a change in anticipations is quite difficult.

9.1 NOMINAL STABILITY

In previous chapters it was repeatedly emphasized that Chile has a long history of considerable inflation. Since World War II, for example, the rate of increase of the GDP deflator has averaged over 35 per cent per year!

In this section three questions are taken up concerning the impact of the foreign sector on domestic price changes: ¹ (i) Has there been a relation between the rate of inflation and the degree of liberalization? (ii) To what extent have international price increases contributed to the Chilean inflation? (iii) What have been the implications of liberalization for Chilean prices?

9.1.1 Relation of Inflation to Exchange Control Phases.

In every more liberal phase since the Great Depression, the mean rate of inflation fell (line 2.1 in Table A.1). In every more restrictive one, it increased.² With no further information one *might* be tempted to posit some inverse causal relation between liberalization and inflation. The real explanation, however, is that the three major liberalization attempts were each part of a stabilization program which met with some initial success.³ Instead of reducing inflation, in fact, liberalization itself *ceteris paribus* probably intensified inflationary pressures (see subsection 9.1.3, below).

9.1.2 Contribution of International Price Increases to Chilean Inflation.

Examination of the annual rates of change of foreign trade unit values reveals that in many instances, external price changes undoubtedly fed the Chilean inflation. The percentage increase in the unit value of imports (measured in U.S. dollars) averaged 15.2 in 1940-46, 23.6 in 1947, and 16.8 in 1951. The percentage increase in the unit value of exports (measured in U.S. dollars) was 16.2 in 1946, 31.4 in 1947, 26.5 in 1951, 15.4 in 1952, 14.4 in 1956, and 11.4 in 1959. For both imports and exports, moreover, increases in external prices were relatively high in the late 1960s and early 1970s.

On the average, however, internal price rises far outpaced external ones. For the 1945-65 period, for which consistent data are available, for example, the mean percentage increase in the unit value of imports was only 2.1 and that for exports was 5.1. The mean percentage rate of growth in the GDP deflator, in contrast, was 29.6. Although international price movements at times contributed significantly to Chilean inflation, therefore, generally they were not a dominant factor.

9.1.3 Price Impact of Liberalizations.

Much of the Chilean reluctance to liberalize and reduce the extent of overvaluation is rooted in fears of the inflationary consequences of such actions.

9.1.3.1 PARTIAL-EQUILIBRIUM ANALYSIS.

In a long-run, perfectly competitive equilibrium with no quantitative restrictions and no water in the tariff, the domestic producer price of interna-

tionally traded commodities would equal the c.i.f. price of the same commodities adjusted for price-related factors in the international economic regime. In such a situation the exchange rate and the prices of nontraded commodities also would have adjusted so that equilibrium existed in international payments and so that the domestic demand for real monetary balances equaled the supply.

Actual Chilean prices, of course, are not at long-run, perfectly competitive equilibrium levels. Instead, they are constantly adjusting in response to substantial shocks, especially in monetary policy and in the international economic regime including varying degrees of use of quantitative restrictions. Thus, to estimate price determinants, sector-specific characteristics of the impact of relevant domestic and international variables and the sector-specific adjustment to those characteristics must be included.

The general specification adopted here is a somewhat eclectic quasi-reduced form with the rate of change of sectoral product prices dependent on both domestic- and foreign-sector factors, some general and some sector-specific. A quasi-reduced form is necessary because the lack of sectoral demand and inventory data precludes direct estimation of structural relations. The rate of change rather than the level of prices is used because the high Chilean inflation rates in the sample period cause so much multicollinearity if levels are utilized that it is not possible to distinguish among competing hypotheses.⁴

Table 9.1 contains estimates of the determinants of the rate of change of Chilean sectoral prices for 1945-65. From an over-all viewpoint these estimates appear quite satisfactory. The corrected coefficients of determination indicate that the specification is consistent with from 0.90 to 0.98 of the variance in the dependent variable over the sample period. No serious problems of serial correlation are obvious. The estimated coefficients generally have the anticipated signs.

Much of the explanatory power lies in the domestic-sector variables. General domestic factors include a dummy variable for the initiation of stabilization programs and rates of change in the monetary supply, real GDP, an NBER-type index of current activity, the total inventory level relative to total GDP, and the distribution of factoral income and sectoral product. Sector-specific domestic factors include the rates of change in total real sectoral demand (including exports) relative to real sectoral output, sectoral capacity utilization, intermediate-input prices (by means of which the influence of monetary changes may be transmitted partially or totally in some sectors),⁵ real sectoral unit labor costs (including employers' social security tax contributions), and real sectoral average labor productivity. An extensive discussion of these factors is given in Behrman [1974].⁶ However, it should be emphasized that a substantial indirect impact of the international economic regime may be trans-

TABLE 9.1
Determinants of the Rates of Change of Chilean Sectoral Prices, 1945-65

| Dependent Variable: | Rates of Change in Domestic Variables | | | | | | | | | | | | |
|---------------------|---------------------------------------|------------------------------|-------------------------------|---------------------------|-----------------|----------------|--------------------------------|-----------------|-----------------------------|------------------------------------|------------------------------|-----------------------------|------------------------------|
| | Money Supply ^b | | | Real Product ^c | | | Economic Activity ^a | | | Unit Real Labor Costs ^d | | Av. Real Labor Productivity | Sector-Specific ^e |
| | Order of Polynomial | | | Indicator | | | Alternative | | | 1-Yr. Lag | | | |
| | 1 | 2 | 3 | 1 | 2 | 3 | Current | 1 | 2 | Interm. Input Prices | No Lag | Lag | |
| Agriculture | | | | | | | 0.417 (2.2) | -0.715 (2.2) | 0.890 (10.0) | | | | |
| Mining | | | | | | | 0.217 (2.4) | | | | 0.160 (3.9) | | |
| Construction | -0.648 [*] (4.2) | 0.187 (3.3) | -0.0167 [*] (3.0) | | | | 1.21 (3.0) | 0.378 (3.1) | 0.478 (7.6) | 0.191 (2.9) | | -1.37 (3.8) | -0.515 (5.1) |
| Industry | -1.24 (8.0) | 0.433 (7.3) | -0.0414 (6.9) | 0.250 (2.9) | | | | | 0.357 (2.4) | 0.0623 (1.3) ⁱ | 0.0891 (1.5) ^m | | -0.146 (4.6) |
| Transportation | | | | | | 0.634 (4.5) | | -1.05 (2.7) | 0.298 ⁿ (3.1) | 0.145 (3.5) | 0.298 (3.1) | | |
| Utilities | -0.621 (3.2) | 0.163 (2.2) | -0.0128 (1.7) | 0.566 (3.7) | | | | | | | | | |
| Housing | -0.0465 (5.9) | | | 1.814 (4.0) | -0.236 (3.6) | | | | | | 0.125 (3.5) | | 1.12 (5.1) |
| Services | -0.111 [*] (2.2) | 0.0128 [*] (2.2) | | | | | | | 1.03 (8.7) | 0.272 (4.3) | | -0.776 (4.8) | -0.509 (6.0) |

(continued)

TABLE 9.1 (concluded)

TABLE 9.1 (concluded)

| Dependent Variable: Rates of Change of Sectoral Product Prices | Rates of Change in Foreign-Sector Variables | | | | | | | \bar{R}^2 SE DW |
|---|---|----------------------------|--|-------------------------------------|---|-------------------------------|------------------------------|-------------------------|
| | Exchange Rate ^a | | Relative EER for Interm. Inputs ^b | Ffrench-Davis QR Index ^c | Prior Deposits ^d or Sector-Specific Constant | | | |
| | Order of Polynomial | 2 | | | | | | |
| Agriculture | -45.2 (1.5) ^m | 5.43 (1.5) ^m | 0.283 (2.9) | | | | | 0.93 0.050 2.0 |
| Mining | | | 0.0854 ^a (2.8) | | 0.749 (15.6) | | | 0.98 0.040 2.3 |
| Construction | | | 0.191 (2.0) | -0.903 (1.8) | -1.04 (2.0) | 0.0599 (1.8) | | 0.93 0.039 2.1 |
| Industry | | | | | -0.0091 (2.9) | 0.128 (1.4) ^m | | 0.98 0.033 2.6 |
| Transportation | | | 0.492 (3.8) | 0.470 (3.5) | 0.992 (1.6) ^m | -0.0015 (2.4) | -0.295 (3.8) | 0.94 0.047 2.3 |
| Utilities | | | | | 0.204 (3.8) | 0.232 (1.8) | | 0.97 0.036 2.6 |
| Housing | | | -0.234 (1.9) | | -0.325 (2.4) | | | 0.90 0.062 2.3 |
| Services | | | | | -1.66 (2.7) | -0.0041 (1.4) ^m | 0.0467 (1.5) ^m | 0.98 0.036 3.0 |

Notes to Table 9.1

R^2 = coefficient of multiple determination adjusted for degrees of freedom.

SE = standard error of estimate.

DW = Durbin-Watson statistic.

a. The figures in parentheses are the absolute values of the t statistics, each of which is significantly nonzero at the 5 per cent level unless otherwise noted. Since the variables are in the form of rates of change, the point estimates are elasticities. In those cases in which the lagged dependent variable is included, the Durbin-Watson statistic is biased toward 2.0. For data sources, see Behrman [1974].

b. The Hall-Sutch [1969] polynomial method (without a tail) is used over a six-year period. The implied lag patterns are as follows:

| Sector | Lag (no. of years) | | | | | |
|--------------|--------------------|-------|-------|-------|-------|-------|
| | 0 | 1 | 2 | 3 | 4 | 5 |
| Construction | .770 | .290 | .088 | .056 | .098 | .113 |
| Industry | .819 | -.034 | -.270 | -.136 | .119 | .247 |
| Utilities | .642 | .171 | -.052 | -.103 | -.060 | -.000 |
| Housing | .279 | .232 | .186 | .139 | .093 | .046 |
| Services | .203 | .105 | .033 | -.014 | -.035 | -.030 |

c. The Hall-Sutch [1969] polynomial method (without a tail) is used over a six-year period. The implied lag patterns are as follows:

| Sector | Lag (no. of years) | | | | | |
|-----------|--------------------|--------|-------|-------|-------|-------|
| | 0 | 1 | 2 | 3 | 4 | 5 |
| Industry | -1.50 | -1.25 | -1.00 | -0.75 | -0.50 | -0.25 |
| Utilities | -3.40 | -2.83 | -2.26 | -1.70 | -1.13 | -0.57 |
| Housing | -2.37 | -0.797 | 0.308 | 0.940 | 1.10 | 0.786 |

d. The NBER-type indicator of current economic activity is unlagged, as are the variables used in alternative 1. The variable for agriculture and mining is the ratio of total real sectoral demand to total real sectoral output; for construction, sectoral capacity utilization. The alternative-2 variables are taken with a one-year lag. For agriculture, the variable is the ratio of total current inventory to total GDP; for construction, sectoral capacity utilization; and for transportation, the ratio of total inventory to total GDP.

e. Includes employers' share of social security tax.

f. For construction and services, the dependent variable is lagged. The underlying variable for industry is a stabilization dummy with a value of 1.0 in 1956, 1957, 1960, 1961, and 1965, and 0.0 otherwise. For housing, the variable is the share of GDP originating in agriculture.

g. The Hall-Sutch [1969] polynomial method (without a tail) is used over a six-year period. The implied lag pattern for the sector is as follows: no lag, 0.0763; one year, 0.0364; two years, 0.0073; three years, -0.0104; four years, -0.0181; five years, -0.0145.

h. For agriculture, the underlying variable is the ratio of the domestic price index for agricultural products to the U.S. wholesale price index, the whole as a ratio to the national accounts EER. For construction and for housing, the variable is lagged one year.

i. For utilities, the underlying variable is the ratio of the black-market NER to the national accounts NER; for housing, it is the ratio of the domestic GDP deflator to the U.S. GDP deflator adjusted for the average import-tax rate and the average prior-deposit rate.

j. For mining, the underlying variable is the unit value of mining exports multiplied by the national accounts NER; for construction, the QR index is lagged one year. Note

that the prior-deposit variable used is the change in the cost of prior deposits, not the rate of change in the cost.

- k. The underlying variable is the ratio of the money supply to real GDP.
 - l. Significantly nonzero at the 15 per cent level.
 - m. Significantly nonzero at the 10 per cent level.
 - n. This variable is lagged one year for this sector.

mitted through some of these variables, especially through the money supply, real product, intermediate-input prices, and sectoral demands.

Some element of the international economic regime apparently is a significantly nonzero direct determinant of the rate of change of prices in every sector:

Price-related factors have a significantly nonzero impact in five of the eight sectors. These factors include expectational effects of exchange-rate changes,⁷ cost-push factors related to imported intermediate inputs,⁸ and international prices.⁹ The estimates imply the highest relative responses to devaluation in the export-oriented mining sector and in the relatively import-dependent transportation sector.

Quantitative restrictions have significantly nonzero effects on price changes in five of the eight sectors.¹⁰ The largest positive response is in transportation, which seems consistent with the relatively large impact of quantitative restrictions on transportation imports that is discussed in subsection 6.2.1 above. However, negative responses are suggested for three sectors having nontradable output: construction, housing, and services. This might be rationalized as reflecting an inverse relationship between quantitative restrictions and the availability of inputs and credit to these sectors, but such an explanation seems somewhat forced.

For industry, transportation, and services, finally, evidence exists of one further significantly nonzero direct link between the international economic policy regime and price changes. In these three sectors especially, when prior import deposit requirements are increased, part of the banking system credit is absorbed and inflationary pressure is reduced.

The partial-equilibrium estimates, then, suggest that the most important direct determinants of sectoral price changes are domestic ones, especially the money supply. The impact of the foreign sector, nevertheless, is significant for a number of sectors, even if the questionable inverse responses in the nontradable sectors are ignored.¹¹ Devaluation would be accompanied by increased direct inflationary pressure, particularly for mining, transportation, and agricultural products.

9.1.3.2 GENERAL-EQUILIBRIUM ANALYSIS.

Domestic factors are more important than foreign ones in the partial-equilibrium analysis of price determination. Within a general-equilibrium con-

text, however, international factors may be much more important than in the partial analysis if they have an impact through some of the domestic variables. The nature of the general-equilibrium impact, of course, depends upon what kind of macro model is appropriate for the analysis.

In a classical world with price flexibility and an exogenous money supply and no quantitative restrictions, devaluation leads to changes in relative prices but not in the over-all price level. Such assumptions have little relation, however, to recent Chilean experience. Product and factor prices have not been flexible because of conditions resembling "unlimited supply of labor" in the traditional sector, strong unionization and administered prices in parts of the modern sector, and government minimum-wage and price-ceiling legislation. Quantitative restrictions have been used extensively (see Part II, above).¹² Determination of the money supply has not been entirely exogenous. Therefore the economy has not been at full employment as in a classical model. Instead, during the two post-World War II decades, forgone output due to underutilization of capacity equaled almost a year and a half of actual output!¹³

A Keynesian-like model is much more appropriate for short-run analysis of the Chilean economy because of the presence of price rigidities and underutilized capacity.¹⁴ A simple Keynesian model is given in Appendix C which can be used to explore the price impact of devaluation and of changing quantitative restrictions.

A Keynesian National Income Determination Model. Consider the situation in which anticipated inflation, nominal wages, and the money supply are all assumed to be exogenous. Relationship C.15' in Appendix C gives the total differential of prices under these assumptions. Devaluation and increased quantitative restrictions both probably increase the price level. Both work to increase aggregate demand. Both will have greater price impact the larger the absolute value of the marginal propensity to consume out of disposable income, the interest rate response of the demand for real monetary balances, the second derivative of production with respect to labor, and the sensitivity of the marginal product of capital to changes in the size of the employed labor force.¹⁵ Both will have greater price impact the smaller the absolute value of the marginal tax rate, the marginal propensity to import out of income, the consumption response to real interest rates, the sensitivity of desired real monetary balance to income, the marginal product of labor, the sensitivity of investment to discrepancies between the marginal product of capital and the cost of capital, and the responsiveness of import demand to the domestic price level. Devaluation will increase prices more the larger the responses of exports and imports to the exchange rate and of taxes to imports and the smaller the sensitivity of taxes to exports. Increases in quantitative restrictions will increase prices more the larger the marginal propensity to consume, the sensitivity of taxes to imports, and the response of imports to quantitative restrictions.

For reasonable values of the parameters in relationships C.15', the inflationary impact of devaluation or of increased quantitative restrictions may be quite substantial. But that is not the whole story. The effect of three variables—anticipated inflation, nominal wages, and the money supply—which were assumed to be exogenous to obtain C.15', apparently has been to increase the inflationary impact of devaluations.¹⁶ Anticipated inflation has been related to exchange-rate policy in at least two ways:

i. Several Chilean governments—most notably under Alessandri in the stabilization attempt of 1959–61 and under Allende in 1970–71—explicitly used a fixed NER as a symbol of their quest for price stability. When devaluation finally was forced because of foreign-exchange crises, inflationary expectations soared. At other times, the NER has not been an official symbol of price stability, but it has been a widely known unofficial indicator of probable price movements.

ii. Under the more restrictive trade regimes the government often has favored the importation of items with large weights in the domestic price indices. The hope has been that such expanded supplies would lessen price increases for these items, lower measured inflation, and thus reduce inflationary expectations. To the extent that liberalization has resulted in more unified exchange rates, of course, this phenomenon has been reversed.¹⁷

Nominal wages have not been exogenous, but have responded to price expectations which, in part, directly and indirectly reflected exchange-rate movements.¹⁸

The money supply has reflected foreign-sector policies in a number of respects:

i. The monetary base has varied substantially in its dependence on foreign exchange and gold. Before the Great Depression and in its early stages this direct dependence was almost complete. This led to very deflationary monetary policies at the start of the 1930s. Owing to the fall in the Central Bank's reserves of more than 58 per cent between the end of 1929 and mid-1931 and to a misguided stubbornness in maintaining the gold standard, for example, the money supply declined by 38 per cent, the real rate of interest was allowed to increase by 50 per cent (in hopes of lessening gold outflows), and the wholesale price index dropped by 16 per cent. In mid-1931, after an abrupt change in the foreign trade regime and the resignation of President Ibañez, a cheap-money policy was adopted.

In subsequent years, according to estimates by Luders [1970:15], there was much less direct dependence of total monetary emissions on Central Bank foreign exchange and gold operations. They were less than a fifth of the total monetary base in the 1931–39 subphase, somewhat over a third in 1940–46, and often less than that in the post-World War II phases and subphases. Nevertheless, changes in foreign-exchange reserves due to variations in the

balance-of-payments surplus have had substantial effects on the monetary base. The Central Bank usually has not been able to neutralize more than a limited part of these changes because of the limited effectiveness of its policy instruments. As a result, both devaluation and increased quantitative restrictions have caused additional indirect inflationary pressure through their impact on foreign-exchange reserves and on the monetary base (see the discussion of C.10' in Appendix C).

ii. The monetary base has also depended indirectly on the foreign sector through the impact of the international economic policy regime on the magnitude of the government deficit financed internally. Much of the impact has been on the revenue side. Important foreign-sector-related direct revenue sources have included import taxes, export taxes, direct taxes on large-scale mining, participation in profits of large-scale mining, and net revenues from exchange-rate differentials.¹⁹ There has been a secular reduction in the relative direct dependence of the government on the foreign sector for tax revenues. Taxes related to foreign trade averaged 83 per cent of total taxes in 1908-27, 34 per cent in 1940-55, and about 21 per cent in 1956-70 (line 1.2.6.6 in Table A.1).²⁰ This decline partially originated in the conscious development of alternative domestic sources of revenue in order to reduce dependence on the foreign sector. It also has reflected the indirect and not clearly intended impact of some of the policies discussed in Part II above. These policies have discouraged exports and created the need to restrain imports, both of which have lowered trade-related tax revenues.

The impact of devaluation on the real value of tax revenues depends on the magnitude of increased revenues from expanded production and exports in comparison to probable reduced revenues from imports²¹ and from reactions to increased anticipated inflation (relations C.5', C.6', C.9', C.14', and C.15' in Appendix C).²² The net effect probably is to increase government revenues. The impact of increased quantitative restrictions on real tax revenues depends on the magnitude of increased taxes from domestic production relative to that of reduced taxes from imports (relations C.5', C.9', and C.14').²³ A one-sector model obscures, however, one interesting additional result of quantitative restrictions. The intensification of these restrictions often has favored mass-consumption items over other categories for income-distribution purposes and as part of the attempt to moderate inflationary expectations (see above). For the same reasons, these items generally have had relatively low import tax rates. Therefore, the intensification of quantitative restrictions at times reduced government tax revenues by lowering the average import tax rate because it not merely reduced total imports but changed their composition as well.²⁴ The net effect of all of these factors probably has been to reduce government revenues when restrictions increased.

The major direct impact of the international economic regime on govern-

ment expenditure included the direct financial costs to the government of operating the regime and subsidies associated with the regime. No attempt is made in this study to present econometric estimates for the first of these costs, but evidence for other countries indicates that they may have been rather substantial.²⁵ Explicit subsidies associated with the international economic regime during the 1945-64 period were very limited, although subsequently they were increased as part of the expanded export-promotion programs under Frei and Allende (see subsection 4.2.2). Substantial implicit subsidies were made by use of favorable exchange rates and special regimes for various commodities (see Chapter 3 and sections 4.1 and 6.1). Furthermore, the foreign sector apparently affected government expenditure by substitution between net foreign savings and government savings (see subsection 12.2.3.2). Unless the last effect was quite strong, however, the net impact of devaluation and liberalization probably has been to reduce government expenditures.

Beyond the question of how foreign-sector policy has affected government revenues and expenditures is the question of determining what proportion of the government deficit has been financed externally. To the extent that such deficits have been financed externally *and* that the increased foreign exchange has been used to raise the flow of imports, the monetary base has not been increased.

As is noted in the previous chapter, sources for external financing of the government deficit dried up completely with the Great Depression. In the 1940s and early 1950s they increased somewhat, but still were not of major importance. As part of the stabilization and liberalization efforts of 1956-58 and 1959-61, however, government deficits were financed mainly abroad. The aim was to reduce inflationary pressures.²⁶ In addition to some short-run attainment of this goal, one result was a considerable addition to Chile's foreign debt.

iii. The foreign sector has not only affected the monetary base, but also has altered the money multiplier. Behrman [1974] gives estimates of behavioral relations which determine the money multiplier. These estimates together with the results presented in Appendix C suggest that devaluation has increased the money multiplier by reducing the currency-to-money ratio (owing to higher interest rates and higher income), the reserve-to-deposit ratio (owing to higher interest rates and higher anticipated inflation), and the ratio of time deposits to money (owing to higher anticipated inflation). They imply some counteracting tendencies of devaluation to reduce the money multiplier by increasing the ratio of time deposits to money (owing to higher interest rates and a higher PLD-NER, which affects expectations) and the currency-to-deposit ratio (owing to the higher PLD-NER).²⁷ The net effect on the monetary multiplier probably has been expansionary.

iv. Several additional relations between foreign-sector policy and the money supply merit mention in passing. Increases in prior-deposit requirements

on imports have had the deflationary effect of absorbing part of the money supply (especially after such deposits were switched from the banking system to the Treasury in the 1960s). Devaluation also has had an additional deflationary effect not mentioned above, since at least a portion of the premiums previously received by importers has been transferred to the government. Given that imports generally have exceeded exports, devaluation has had a further deflationary effect, since more domestic currency has been required after a devaluation to finance the same dollar value of deficit as before.

General-Equilibrium Implications. The model in Chapter 2 provides a framework for evaluating the empirical magnitude of general-equilibrium price responses to changes in NERs and quantitative restrictions. This model roughly parallels the one in Appendix C on a multisector level, with the incorporation of inflationary anticipations, wages, and the money supply as endogenous variables.

For simulation 2.1.1 in Table A.11, equal proportional changes are assumed in all NERs, *ceteris paribus*, in the first year only (1962). The first-year price elasticity is 0.6, and the third-year elasticity is 0.3.²⁸ This quite positive price response partially reflects a response in the money supply due to increased international reserves, reduced net free reserves, and the changed composition of money demand. Also of importance are the direct price and price expectational links and a positive relation to the ratio of net demand to net supply as the foreign trade flows change (see subsection 9.1.3.1).

The widespread reluctance of Chileans to devalue because of an anticipated negative short-run inflationary impact, then, is well-founded. Such price increases, moreover, undo much of the potential positive effects of devaluation on the balance of payments (see subsections 6.2.2.1 and 7.2.2.1). Unless much more powerful monetary tools are developed, however, Chile cannot avoid the intensification of inflationary pressures from devaluation.

For simulation 2.3 in Table A.11, equal proportional changes are assumed in all quantitative restrictions, *ceteris paribus*, in the first year only. The general-equilibrium elasticities of price are quite high, 1.6 in the first year and 1.5 in the third. These sizable responses primarily reflect the impact of quantitative restrictions on the money supply through changes in international reserves. Such results lead to more optimism about the short-run impact of liberalization than does consideration of simulation 2.1.1 in isolation. If liberalization accompanies devaluation, the price effects of the former will at best partially offset the inflationary consequences of the latter. This counteracting tendency has been too often ignored in discussions of the short-run consequences of devaluation and liberalization in the Chilean economy.

9.2 REAL FLUCTUATIONS

Variations in real output are a second short-run concern. A frequently encountered criticism of Chilean liberalization efforts is that they have caused losses in real output and employment. In this section, three questions regarding this charge are taken up: (i) Have there been phase-associated fluctuations in capacity utilization?²⁹ (ii) Have capacity-utilization rates been sensitive to foreign-sector changes on a partial-equilibrium basis? (iii) What has been the general-equilibrium response of capacity utilization to changes in the international economic regime, *ceteris paribus*?

9.2.1 Associations of Capacity-Utilization Rates with Exchange Control Phases.

A simple association between the mean capacity-utilization rates for phases and subphases and the degree of liberalization is not evident (line 2.2 in Table A.1).³⁰ The highest means are for the Phase II periods of 1962-64 and 1971-73.³¹ Next is that for the Phase III years of 1965-70,³² followed by that for the type-II subphase of the Second World War.³³ The lowest average by far was for 1931-39 and was due to the impact of the Great Depression (see section 1.3). Next lowest were those for the Phase II years of 1947-51 and Phase III years of 1956-58.³⁴ The mean rose from that of the previous period for the 1959-61 Phase IV liberalization, but fell for the two Phase III liberalizations.

That lack of a simple association is not surprising: capacity utilization is largely determined by domestic factors rather than foreign ones (see subsection 9.2.2). Much of the importance of the foreign sector in the determination of capacity utilization, moreover, has been due to wars and export-market fluctuations. These phenomena are beyond Chilean control. They clearly are not caused by any changes Chile might make in her international economic policy regimes.

On the other hand, Chilean policy probably somewhat exacerbated short-run instability in real terms. Overvaluation effectively discouraged greater diversification in exports, which would have reduced vulnerability to international fluctuations (see Chapter 7) and led to restrictions on imported inputs at times of balance-of-payments crisis.

9.2.2 Partial-Equilibrium Determinants of Capacity Utilization.

Table 9.2 contains regression estimates of the determinants of capacity utilization for eight Chilean sectors in 1945-65. In the underlying model real

Notes to Table 9.2

\bar{R}^2 = coefficient of multiple determination adjusted for degrees of freedom.

SE = standard error of estimate.

DW = Durbin-Watson statistic.

a. Each independent variable is multiplied by the sectoral capacity of real GDP. Except as indicated in the notes, the variables are not lagged. The figures in parentheses below the point estimates are the absolute values of the t statistics. All point estimates are significantly nonzero at the 5 per cent level unless otherwise noted. The figures in brackets are the elasticities at the point of sample means. Behrman [1974] gives data sources and further details.

b. Public credit only for mining; private credit only for housing; public plus private credit for services.

c. Ratio of imports of staple consumer goods to agricultural capacity for agriculture; ratio of intermediate imports to total GDP for mining; and ratio of lagged total imports to lagged total GDP for housing.

d. Sum of value of real government direct and indirect investment, depreciated at rate of 3 per cent through past year, as ratio to total real GDP.

e. Ratio of product price, adjusted for direct and indirect taxes, to unit labor costs including employers' social security contributions.

f. Ratio of noninventory investment to GDP.

g. Significantly nonzero at the 10 per cent level.

h. Significantly nonzero at the 15 per cent level.

i. Ratio of domestic GDP deflator to United States GDP deflator adjusted for the average import tax rate and the average prior-deposit rate.

j. Ratio of product price, adjusted for direct and indirect taxes, to material input price index.

k. Ratio of total inventory level to GDP.

l. Average indirect tax rate.

m. Rate of change of GDP deflator.

n. Lagged dependent variable (*not* multiplied by sectoral capacity). For this sector the Durbin-Watson statistic is biased toward 2.0.

o. Ratio of product price, adjusted for direct and indirect taxes, to wages adjusted for employers' social security contribution.

sectoral GDP³⁵ adjusts toward a level determined by the desired capacity-utilization rate and actual real sectoral capacity.³⁶

On an over-all level these estimates appear to be quite satisfactory. The corrected coefficients of determination imply that the results are consistent with from 94 to 98 per cent of the variance in the dependent variable over the sample period. Evidence of considerable problems of autocorrelation does not appear. The signs of the significantly nonzero coefficient estimates generally are those anticipated a priori.

Variations in sectoral real capacities underlie much of the fluctuation in real product, but the variations in the desired sectoral capacity-utilization rates also are quite important. Among the domestic determinants of the desired utilization rates, significantly nonzero coefficients are obtained in at least three sectors for price ratios of product to labor input, indices of the change in current economic activity, and relative availability of credit. In addition, there are several significant sector-specific coefficients. A proxy for public infrastruc-

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[0.7]

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ture development affects agriculture. The level of over-all investment influences utilization in construction. The 1960 earthquake reduced utilization in construction and increased it in housing. Indirect taxes discouraged production particularly in transportation and housing. Anticipated inflation has induced higher production in utilities.

Space limitations preclude discussion of these factors here. Some of them, however, have important roles in the indirect transmission of the impact of foreign-policy changes which are included in the general-equilibrium analysis of the next subsection.³⁷

For every sector there is evidence of some direct significantly nonzero impact of the international economic regime on the level of desired capacity utilization. The ratio of competing imports to domestic product is inversely related to real product in agriculture and housing. For the former sector the frequent policies of increasing food imports as part of the anti-inflationary strategy (e.g., through Public Law 480), therefore, may have had a direct negative feedback on subsequent domestic production. The ratio of intermediate imports to product has a significant impact in mining, but not in other sectors. At least for industry the lack of significance of intermediate imports may be somewhat surprising given the hypothesized increasing dependence of that sector on imported inputs.³⁸ Indices of quantitative restrictions (including the ratio of the black-market to the national accounts NERs) have significantly nonzero coefficients for every sector except agriculture. For mining and for transportation these coefficients are negative, which suggests that the restraining effect on production due to limitations on imported inputs together with the association between the use of quantitative restrictions and an overvalued exchange rate which penalizes mining exports are dominant. For other sectors, however, apparently any restraining effects of quantitative restrictions due to imported input shortages are more than offset by increased demand due to shortages of competing imports. For services, furthermore, the significantly positive coefficient of the quantitative restrictions index presumably also reflects the direct use of increased numbers of people to administer the QR regulations.

The direct effects of foreign-sector policies on capacity utilization, thus, have been widespread. They have sometimes, however, been partially offsetting. Indirect effects, moreover, may have been reinforcing or offsetting. To discern the net impact of changes in the international economic regime on capacity utilization, therefore, a general-equilibrium framework must be used.

9.2.3 Impact of Foreign-Sector Policies on Capacity Utilization Within a General-Equilibrium Framework.

The model of national income determination in Appendix C gives an insight into the impact on production of changes in NERs and quantitative re-

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restrictions. If price anticipations, nominal wages, and the money supply are exogenous, relationship C.14' gives the comparative static effects of such changes on production. Both devaluation and intensified quantitative restrictions probably increase aggregate demand and therefore production. The effects of changed marginal propensities and productivities on the size of these increases generally are the same as is discussed in subsection 9.1.3.2, above. However, the impact is greater the higher the marginal product of labor and the lower the second derivative of production with respect to labor, instead of vice versa.

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The arguments presented in subsection 9.1.3.2 for the endogenism of price anticipations, nominal wages, and the money supply again hold for devaluation and also, in the case of the money supply, for changes in quantitative restrictions. Induced increases in anticipated inflation and in the money supply both probably increase aggregate demand and production. Therefore, they reinforce the effects noted in the previous paragraph. Induced rises in the nominal wage, however, have the opposite effect because the aggregate supply curve moves up owing to higher labor costs (relation C.12') and the aggregate demand curve moves down owing to reductions in the incentive to export because of higher labor costs (relations C.6' and C.14').

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The model in Chapter 2 again provides a framework for evaluating the empirical magnitude of general-equilibrium production responses to changes in NERs and quantitative restrictions. In this model sectoral capacity-utilization rates are determined by the estimates in Table 9.2. Therefore, direct effects of quantitative restrictions on production are incorporated, in contrast to the more simplified model of Appendix C.

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Simulation 2.1.1 in Table A.11 explores the impact of equal percentage changes in all NERs, *ceteris paribus*, for the first year only of the simulation. The first-year response is inverse, although quite small in absolute value. The positive responses in most other sectors almost offset the negative responses in industry, services, and housing. The third-year elasticity is positive, although still quite small at 0.1.³⁹

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Under the assumption that employment rates are highly correlated with capacity-utilization rates, these results *prima facie* contradict the Taylor and Black [1973] estimates of an employment elasticity of 0.9.⁴⁰ This discrepancy reflects the consequences of three different sets of assumptions in the two models: (i) Taylor and Black posit immediate adjustment in the labor market and no adjustment in the capital stock, while the model used here has lagged adjustments for both labor and capital; (ii) Taylor and Black maintain the nominal wage constant when they change the exchange rate, but considerable wage adjustment occurs in simulation 2.1.1;⁴¹ (iii) Taylor and Black exclude a number of indirect effects that are passed through the monetary system but which are incorporated here.

Although the labor-adjustment mechanism in the present study may be somewhat too slow and, therefore, the true value of the first-year employment elasticity may be positive, a general-equilibrium value approaching that presented by Taylor and Black seems quite unlikely. More probable is a conclusion consistent with the results presented in Table A.11. The first-year employment-capacity utilization impact is likely to be very small—and possibly inverse. The medium-run impact is likely to be positive, although still not very large.⁴² These results support the conventional Chilean wisdom that devaluation has a very limited and possibly negative short-run impact on production.⁴³

Simulation 2.3 in Table A.11 investigates the effects of equal proportional changes in all quantitative restrictions, *ceteris paribus*, in the first year only. The protective effects of quantitative restrictions on competing final goods apparently dominate effects on imported input supplies. The elasticity of real capacity utilization is 0.1 in the first year and 0.2 in the third year.

The total implications of these two simulations are not very encouraging for liberalization programs. They imply that devaluations together with reductions in quantitative restrictions almost certainly will cause a drop in capacity utilization rates. Offsetting expansionary fiscal and monetary policies might be called for. However, such policies would feed the already considerable inflation unless spiraling inflationary expectations were radically lowered. Such a re-adjustment of price anticipations may be possible only with substantial short-run political or economic dislocations or both—a topic far beyond the subject of this book.

NOTES

1. The related question of how price changes affected the international economic policy regimes is considered in Chapter 13.

2. In Table A.1 only 1971 is included for the Phase II Allende period. In 1972 the inflation rate exceeded 160 per cent, and in 1973 it rose to an even higher level.

3. During the Phase III 1965–69 period, however, much of the liberalization occurred after the abandonment of price stabilization attempts.

4. The adjustment processes are represented by the Hall-Sutch [1969] polynomial method (without a tail) over a six-year period for the rates of change of the money supply and real GDP and for expectations regarding the rate of change of the NER. Other adjustments are represented by the possibility of a geometric process for the dependent variable or by simple lags for other variables.

5. Intermediate-input prices include the price of imported components and, thus, the direct impact of the international economic regime.

6. Alternative estimates are in Behrman [1973c], Corbo [1971:198–201], García [1964], Harberger [1963], and Yver [1970].

7. The NER changes also may represent a cost-push factor in that the local-currency cost of external indebtedness increases as the NER increases.

8. The results suggest that the rate of growth of the price of services declines relatively when these imported inputs increase relatively in price.

9. For no sector is there evidence of a significant response to rates of change of import unit values multiplied by the EER or to sectoral imports relative to domestic absorption.

10. To the extent that changes in quantitative restrictions only changed the premiums going to traders with import licenses, of course, these changes did not affect sectoral prices.

11. Behrman [1974] includes estimates for the determination of the rate of change of deflators of final demand components that suggest similar conclusions. Among that group devaluation would have the strongest direct impact on exports, imports, and investment. Quantitative restrictions have a fairly pervasive direct impact, including an inverse relationship for the export deflator, apparently because use of such restrictions makes possible continuance of an overvalued NER.

12. Sohmen [1958:271-273] demonstrates that prices must decline after devaluation if economic welfare increases when quantitative restrictions, import taxes, etc., are used. However, he assumes that money national income is kept constant due to monetary and fiscal policies and that full employment is maintained. Such assumptions are not appropriate for recent Chilean history.

13. This estimate is from Behrman [1973b:256]. It is very conservative because it is based on a trend-through-the-peaks capacity definition which refers to shortfalls from actually attained rather than potential production levels.

14. A Keynesian model is much more appropriate in the Chilean case than for most developing economies because the nonmonetized sector is quite small, saving and investment decisions often are separated, and there is some evidence of a significant role for interest rates (see Behrman [1972b]). On the other hand, comparative statics analysis with a Keynesian model has many of the same limitations in the Chilean case as in the case of more developed economies. Probably most important is the focus on equilibrium solutions rather than disequilibrium adjustments. Despite the burgeoning recent literature on disequilibrium, however, at this time the state of the art does not permit satisfactory analysis of disequilibrium behavior except under very particular ad hoc assumptions.

The term "Keynesian model" is *not* used here to mean a case in which all focus is on aggregate demand, and supply considerations are ignored. To the contrary, an aggregate production function is explicitly included (see Appendix C).

15. If the sign of any dependent term cited here or subsequently is ambiguous, but one sign is much more likely than the other, given the available empirical evidence or a priori expectations or both, no qualifications are made, both because of limitations of space and because of the complexity of the explanation.

Space limitations also preclude a detailed explanation of why these dependencies are of the indicated sign (e.g., the more sensitive the marginal product of capital to the number of laborers, the greater is the inducement to invest in response to the expanded aggregate demand which occurs because of foreign trade responses to devaluation). Careful consideration of Appendix C, however, should generally provide any necessary clarification.

16. For changes in quantitative restrictions, the behavior of the money supply has not been exogenous.

17. In the 1956-58 effort at stabilization plus liberalization, for example, the imported component of the wholesale price index rose quite substantially (about 30 per cent) relative to the over-all index. The relative unification of NERs resulted in rather large effective devaluations for some of the "essential" imports (e.g., sugar, coffee, Para-

guayan tea) which previously had been more favored and which had disproportionately large weights in the price indices. Likewise the changes in the regime caused relatively large increases for export and mining-related price indices owing to the reduction of discrimination against key products included there.

18. For evidence see Behrman [1971a,1974] and Behrman and García [1973].

19. Not all of these sources are independent. The tax function estimates in Behrman [1974], for example, imply a direct trade-off between government revenues from NER discrimination for the legal cost of production of large-scale mining and government revenues from direct taxes on large-scale mining. For every escudo increase in the legal cost of production due to the former, revenues from direct taxes decreased by 0.41 escudos (after the *Nuevo Trato*).

20. The 18 per cent figure for 1965-70 in Table A.1 is misleading in a sense because government participation replaced some direct taxes in large-scale mining.

21. Imports decline if the price and exchange-rate effects in relation C.5' outweigh the income effect.

22. For evidence of an inverse relation between taxes and expected inflation in Chile see Behrman [1974]. This reaction reflects the incentive to postpone tax payments when expected inflation is high because the nominal penalties for late payment do not offset the expected capital gains from postponement until prices have increased.

23. It is assumed that the quantitative restrictions in fact do reduce imports despite the increase in import demand due to over-all expanded aggregate demand.

24. A regression of the logarithm of nominal import taxes (TXM) on the logarithm of the nominal value of imports (M), a secular time trend ($TIME$), an anticipated inflation variable to represent tax avoidance (π), and an index of quantitative restrictions (QR) provides some weak support for this hypothesis:

$$TXM = 0.610 M + 0.116 TIME - 0.0029 \pi - 2.71 QR + 1.63$$

$$(6.3) \quad (3.7) \quad (2.0) \quad (1.7) \quad (1.0)$$

$$\bar{R}^2 = 0.997; SE = 0.101; DW = 2.0; \text{years covered, 1945-65}$$

25. See Bhagwati and Srinivasan [1975] and Krueger [1972b] for examples.

26. The external financing was supposed to be an interim measure while fiscal reforms were enacted.

27. The institution of dollar deposits in 1959-61 also lowered the money multiplier by increasing the ratio of time deposits to money.

28. For a sustained devaluation, such as in simulation 2.1.3, the third-year price impact is much larger than in this case due to the cumulative effects. For both simulations 2.1.1 and 2.1.3 the first-year estimates are quite comparable to the range of 0.48 to 0.69 which Harberger [1964] presents for a model based in substantial part on his Chilean experience. Harberger assumes a constant nominal money wage rate and complete adjustment to a sustained devaluation. The effect of the first of these assumptions should be to lower his estimate relative to that of the present model, but the effect of the second should be to increase it relatively.

29. A trend-through-the-peak capacity definition is used throughout this section. This definition measures output against attainable capacity (not rated capacity) and therefore gives relatively high utilization rates. Behrman [1973b] and others he cites there discuss the advantages and limitations of this definition.

30. For recent years the Santiago unemployment rate provides supplementary information about the utilization of productive resources (line 2.3 in Table A.1). The movements in this variable reinforce the characterization of short-run developments based on the capacity-utilization measure alone.

31. Table A.1 includes only 1971, but the scanty available evidence suggests that high capacity utilization continued at least into 1972. For example, for January–April 1972 as compared to the same period for 1971, CORFO [1972a, 1/8/72:1–3] reports increases of over 15 per cent for industrial production, industrial use of electrical power, cement production, and shipments of iron and steel products. Also the unemployment rate of the Greater Santiago area on March 1972 was 0.048 as compared to 0.082 a year earlier. The only negative figure concerning the use of real capacity was a decline of 4.4 per cent in kilometer-tons of freight transported by the railroads.

32. As liberalization accelerated later in this phase, however, utilization rates tended to decline.

33. Note that capacity utilization in 1908–27 averaged as high as during the relatively prosperous World War II subphase. This observation raises questions about the structuralists' characterization of Chilean capacity utilization as being very vulnerable to fluctuations emanating from the foreign sector in the period of relatively liberal foreign economic policies before the Great Depression.

34. Critics of the Ibañez-Klein-Saks stabilization program of 1956–58 have focused on this decline, although they have tended to overstate its magnitude.

35. Given capacity, variations in product directly determine variations in capacity-utilization rates.

36. The adjustment process is a geometric distributed lag, but only for utilities do the results suggest significant adjustment extending beyond one year.

37. For further consideration of these results see Behrman [1974]. For an earlier attempt to estimate Chilean capacity-utilization determinants see Behrman [1973b].

38. Anne Krueger has suggested that this impact may be represented by the quantitative restrictions variable. The effect of such restrictions on intermediate imports was explored in section 6.2.

39. By the third year, however, changes in capacity occur. Therefore, the production elasticity no longer is the same as the utilization-rate elasticity.

40. Taylor and Black obtain this estimate when they use the same elasticities of substitution between capital and labor that are utilized in this study. Under the assumption of elasticities of substitution between capital and labor of 1.0, they obtain an elasticity of employment with respect to the NER of 1.7.

41. Taylor and Black acknowledge that a constant nominal wage is not at all probable under exchange-rate adjustments.

42. Within a partial-equilibrium framework de Castro and de la Cuadra [1971:12–13, 20–21] reach the same conclusion for the immediate impact on employment in Chilean industry (although their specification of time periods is not clear). They maintain that for given industrial capacity, the subsectoral increases in the demand for labor originating in exchange-rate alterations would offset approximately the subsectoral decreases.

43. If devaluation induces substantial decumulation of speculative inventories built up in anticipation of the devaluation, the results may not be more deflationary than is suggested by the present model.