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4 Continuity, Change, and the Political Economy of Transition in Chile

Raúl Labán and Felipe Larraín

4.1 Introduction

Since the mid-1970s, the Chilean economy has suffered a profound transformation. From very high levels of protection and pervasive state intervention, it has been transformed into an economy integrated to world markets, where the engine of economic growth is the private sector. The process, however, has not been smooth on the economic front. Two major depressions—in 1975 and 1982–83—tested Chile's resolve in continuing free-market reforms, but the process endured. Political transition from authoritarian rule to democracy was also an important test for the economic model. To some, the opposition's victory in the presidential elections of December 1989 posed grave threats to the economy. These fears proved to be wrong, and in the early 1990s Chile's economic model has been deepened and legitimized in democracy.

This paper analyzes the economic policies pursued by the government of President Patricio Aylwin, which took office in March 1990, and discusses the issue of continuity and change in the policy regime. In an attempt to look forward, it also touches on the main challenges currently facing the Chilean economy. Despite major progress, a significant fraction of the Chilean population still lives below the poverty line. Consolidating a strong and stable path of economic growth is an essential component in the defeat of poverty and underdevelopment. Persistent economic growth on the order of 7% per year is attainable for Chile, but this requires a higher investment and saving effort.

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4.2 The Legacy of the Military Regime, 1973–90

In this section, we briefly review the main economic developments and reforms implemented during the military regime (1973–90) and describe the economic conditions under which Chile returned to democracy after sixteen years of authoritarian rule.

4.2.1 Economic Policy in the Authoritarian Era[1]

The Dramatic Changes of the 1970s: The Chilean Transition to Markets

From the outset of the military regime in late 1973, the Chilean economy began the transition to markets by implementing a number of major economic and institutional reforms aimed at attaining three different objectives: stabilization, privatization, and liberalization. The first two objectives were to be achieved immediately, while liberalization was supposed to be more gradual.

Stabilization amounted initially to the elimination of the imbalances in the goods markets, induced by an excess of government intervention during the previous administration, and in the public sector. By the end of 1974 and during 1975, the efforts concentrated mainly on correcting the balance-of-payments deficit provoked by the collapse in the world price of copper (Chile's main export) and the tripling of oil prices. Finally, it addressed the control of inflation. The stabilization attempt ended by fixing the nominal exchange rate in 1979, which was supposed to play the role of a nominal anchor for the economy. Inflation, however, did not converge to international levels due to widespread indexation in labor and financial markets and to an aggregate spending that was expanding faster than output. This caused an important decline in the real exchange rate and thus in the competitiveness of the tradable sector.

A first round of privatization (1974–78) was centered on the divestiture of most of the real assets that had been transferred to the state during the Unidad Popular administration (1970–73). By 1980, the public sector remained in control of only forty-three firms (including one commercial bank), compared to the more than five hundred firms under state control during President Allende's administration. Privatization was part of a comprehensive attempts to restructure the public sector.

Liberalization involved many reforms aimed at increasing the role of market forces in the economy. The starting point was the freeing of most controlled prices in late 1973, followed by a sweeping deregulation of the domestic financial market and the beginning of extensive trade liberalization. This trend was extended to international financial transactions by the end of the decade and especially during the early 1980s.

1. This section draws on Larraín (1991a, 1991b). For a detailed analysis of economic developments during this period, see also Edwards and Cox-Edwards (1987) and Meller (1990).

In 1979, a major labor reform established collective bargaining at the firm level, relaxed the prohibition on dismissals, and restricted strikes. These reforms to labor legislation reduced the negotiating power of workers vis-à-vis employers (in comparison to the pre-1973 legislation) and were strongly opposed by labor organizations.

By the beginning of the 1980s, Chile had undergone a deep process of economic restructuring. This embodied a dramatic change in the relative roles of the private and public sectors, and increased the role played by markets in the allocation of productive resources. At that time, Chile had market-determined domestic interest rates and prices (with the exception of public wages and the exchange rate), a unified exchange rate system, a uniform 10% import tariff as the only trade barrier (except for automobiles), and a relatively liberalized capital market.

Economic performance experienced wide fluctuations in the period 1974–81. A very large contraction took place during 1974–75, with GDP declining by about 13% and unemployment surging to 16.4% of the labor force in 1975. This was attributable not only to the terms of trade loss resulting from the rise of oil prices and the fall of copper prices, but also to a sharp decline in domestic demand as a consequence of restrictive fiscal and monetary policies, and exchange rate devaluation, which sharply reduced real wages—by 15.6% during 1974–75 (see table 4.1).

It is difficult to identify how much of the reduction in real wages and the employment losses was due to the economic reforms implemented at that time and how much was due to other shocks. But privatization of state enterprises with overemployment and trade liberalization may be expected to induce, at least in the short run, a decline in living standards and an increase in unemployment.

In 1976–77, the economy recovered from the 1975 depression and then experienced four years of growth at an average rate of 7.5%. The recovery gave way to a boom in 1980–81, spurred by a major shift in expectations, from a realistic assessment of Chile's prospects to an illusion of sustained, high growth. Unemployment, however, remained very high during the complete period.

The opening of the capital account and the abundance of foreign credit in the late seventies and early eighties provided the financing necessary for an unsustainable expansion in private expenditures at the time of the boom. By late 1981, Chile had accumulated a stock of foreign debt approaching US$16 billion. The economy was particularly vulnerable to an increase in interest rates, since almost 60% of the debt was contracted at variable rates, mostly tied to the London interbank offered rate, which in 1981 shot up to 16.5% at the same time that terms of trade declined by 6%. But the worst would come in the following year.

Table 4.1 Selected Macroeconomic Indicators in Chile, 1970–92

Years	GDP Growth[a] (%)	Inflation[b] (%)	Unemployment[c] (%)	Real Wages[d] (%)
1970–73[e]	1.1	218.1	4.4	−8.5
1974–79[e]	2.7	145.2	16.6	6.3
1974–89[e]	3.1	57.3	17.3	3.0
1980–89[e]	3.3	20.5	17.7	1.1
1985–89[e]	6.2	19.8	13.0	1.1
1990–92[e]	5.9	19.6	5.8	3.7
1974	1.0	369.2	9.2	−13.3
1975	−12.9	343.3	16.4	−2.7
1976	3.5	197.9	19.9	10.8
1977	9.9	84.2	18.6	21.5
1978	8.2	37.2	17.9	14.3
1979	8.3	38.9	17.7	10.9
1980	7.8	31.2	15.7	8.7
1981	5.5	9.5	15.6	8.9
1982	−14.1	20.7	26.4	−0.2
1983	−0.7	23.1	30.4	−10.6
1984	6.3	23.0	24.4	0.1
1985	2.4	26.4	21.4	−4.3
1986	5.7	17.4	16.0	2.1
1987	5.7	21.5	12.2	−0.2
1988	7.4	12.7	9.0	6.5
1989	10.0	21.4	6.3	1.9
1990	2.1	27.3	6.0	1.8
1991	6.0	18.7	6.5	4.9
1992[f]	9.7	12.7	4.9	4.5

[a]Central Bank of Chile. Monthly and quarterly reports.

[b]December to December, 1970–78: Cortázar and Marshall (CIEPLAN: Corporacion de Investigaciones Economicas para Latinoamerica 1979–92: Central Bank of Chile.

[c]1970–79: ODEPLAN (National Planning Office); 1980–92: Instituto Nacional de Estadisticas (INE). Includes emergency unemployment programs (PEM and POJH).

[d]1970–73: industrial sector; 1974–92: aggregate index; Instituto Nacional de Estadisticas (INE).

[e]Average annual rates.

[f]Preliminary estimates.

Crisis, Adjustment, Recovery, and Growth (1982–89)

In 1982–83, Chile experienced its worst economic crisis since the 1930s, with real output collapsing by 15%. This major depression was partly a result of several external shocks: the drying up of voluntary external financing, the deterioration of 23% in the terms of trade since 1980, and the major increase in foreign interest rates. But the impact of external developments was exacerbated by several domestic policy mishandlings: the fixed exchange rate policy coupled with mandatory indexation of wages at 100% of past inflation; the sweeping opening of the capital account at the time of the boom; the radical liberalization of domestic financial markets without the provision of proper regulations and controls; and the belief in the "automatic adjustment" mechanism, by which policymakers expected the market to produce a quick adjustment to the new recessionary conditions without interference by the authorities.

The government initially responded to the 1982 external payments crisis with a contractionary adjustment policy during 1982–83, aimed at closing the income-expenditure gap. Output dropped during both years, the unemployment rate reached over 30% of the labor force in 1983, and real wages declined by almost 11% during this period. In addition, the exchange rate policy was erratic, as shown by the implementation of five different exchange rate regimes after the abandonment of the fixed exchange rate policy in June 1982. The external disequilibrium was reduced in 1983, but the economy continued to be depressed. This is not surprising, since most of the adjustment to Chile's external crisis occurred initially through import reduction induced by an aggregate expenditure contraction, while substitution effects in demand and exports showed little response. In 1983, imports were less than 50% of their 1981 level.

In order to prevent the high costs that the adjustment program was inducing, the government pursued an expansionary policy during most of 1984, which helped to achieve a recovery in output but proved to be unsustainable. The current account deficit almost doubled, surpassing US$2 billion—10.7% of GDP. In September of that year, the exchange rate was devalued and tariffs were raised, in order to induce a switch in expenditure toward domestic goods.

At the beginning of 1985, a new macroeconomic policy was implemented. Its aim was to promote a recovery of output and employment through the export-oriented structural adjustment of the economy. Policy actions centered on three fronts: the promotion of noncopper exports, the enhancement of domestic saving and investment, and the strengthening of the corporate and financial sectors.

The heavy burden of a foreign debt in excess of GDP required a vigorous effort to promote exports. At the same time, the need to diversify exports beyond copper had been recognized, and a process of export diversification had been under way since the midseventies. To strengthen this effort, the authorities relied on several policies: a series of devaluations restored first the loss in international competitiveness suffered during the fixed exchange rate period (1979–82), and were followed by the stabilization of the real exchange rate at a competitive level; import tariffs were reduced from 35% to 15% in three steps; and various fiscal and administrative measures were effected, including a 10% import duties rebate on minor exports and an acceleration of existing tax refunds for exporters. While these measures were primarily oriented toward exports, they also provided an incentive for efficient import substitution stemming from the high level of the real exchange rate.

During 1985–89 the volume of exports of goods and services expanded at an average annual rate of 10.5%, and Chile became one of the countries with

Table 4.2 Evolution of Imports, Exports, and the Real Exchange Rate, 1980–92

Year	Import Volume[a] % of Real GDP	Import Volume[a] Annual Rate of Change	Export Volume[a] % of Real GDP	Export Volume[a] Annual Rate of Change	Real Exchange Rate[b] (1980=100)
1980	30.3		23.6		100.0
1981	33.1	15.7	20.3	−9.0	87.0
1982	24.7	−35.3	24.6	4.7	97.0
1983	20.9	−17.9	25.3	0.1	116.4
1984	22.3	13.2	24.4	2.3	121.7
1985	19.6	−10.3	26.9	12.3	149.5
1986	20.9	14.1	27.5	9.7	164.5
1987	23.1	17.0	28.3	8.8	171.5
1988	24.1	12.1	27.9	6.1	182.9
1989	27.4	25.3	29.4	15.7	178.6
1990	27.0	0.6	31.0	7.6	185.4
1991	27.7	8.5	33.0	12.9	175.0
1992[c]	30.7	21.6	34.0	13.1	161.1

[a]Import and exports of goods and services in 1977 pesos, National Accounts, Central Bank of Chile.

[b]Effective real exchange rate, Central Bank of Chile.

[c]Preliminary projections.

higher outward orientation, as exports of goods and services accounted in 1989 for 29.4% of GDP, compared to 23.6% in 1980 (see table 4.2 and figure 4.1).

National saving reached a remarkable low of 1.6% of GDP in 1982. As foreign saving became severely limited, it was imperative to improve the domestic effort in order to finance higher levels of investment. At a broad level, the restoration of macroeconomic stability was essential to increase saving. But specific policies were also pursued. The tax reform of December 1984 promoted corporate saving through a radical reduction in the tax rate affecting retained earnings. Attempting to encourage household saving, the reform also allowed a reduction from the tax base of 20% of certain qualified investments.

Public revenues were hurt by the depressed economic activity, the social security reform of mid-1981 (which required increased public contributions to the state social security system), the 1984 tax reform (which significantly reduced direct taxation), and the reduction of 20% of import tariffs.

In view of weakened public finances, the government implemented a series of measures to improve its financial position. Wage adjustments in the public sector were set systematically below inflation, and social security disbursements ceased to be adjusted automatically to lagged inflation. Several other categories of current and capital expenditures were also curtailed.

During 1982–83, nonfinancial corporations had become very weak—some outright insolvent—as a consequence of extremely high real interest rates, the effects of currency devaluation on dollar-denominated debt, and the economic depression. These factors, coupled with faulty banking practices in a permissive regulatory environment, set the stage for a major crisis in the financial sector, requiring regulators to assume control of several troubled financial institutions, including the two largest private commercial banks.

In the short run, the government reacted to the crisis with a substantial aid package for banks and local debtors. This package included a preferential exchange rate for dollar debts, at times 40% below the official rate; credit lines at below-market rates for the financial sector; and the Central Bank's purchase of bad loans from the banking system with a repurchase agreement, which also involved a subsidy. The various programs were phased out by the end of 1986, but their cost was substantial for the public sector. The total value of subsidies for financial rehabilitation was estimated at approximately US$6 billion, or about 35% of 1986 GDP. In an attempt to avoid the mistakes of the earlier financial liberalization, bank regulation was strengthened, and the regulatory powers of the Superintendency of Banks and Financial Institutions were enhanced. By mid-1985, the authorities started a major recapitalization program for private banks.

During the second half of the 1980s, a second round of privatization was carried out. A total of forty-six firms—a number of financial institutions that were intervened in by the government to keep them from bankruptcy after the economic and financial crisis—were sold to the private sector for slightly over US$3 billion. This process was relatively rapid, given the large number of firms and the volume of the assets sold.

Macroeconomic performance significantly improved after 1984. In 1985, the economy started a sustained recovery, accompanied by a steady improve-

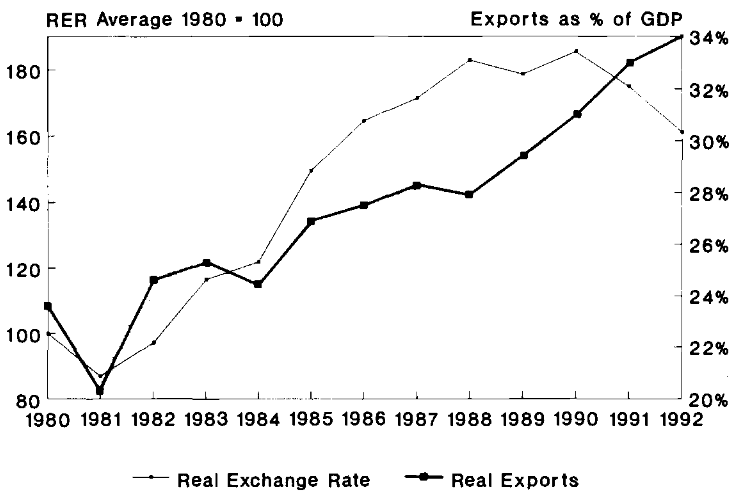

Fig. 4.1 Exports and real exchange rate, 1980–92
Source: Central Bank of Chile, monthly and quarterly reports.

ment in the external accounts. These results came from a combination of internal and external factors. Internally, the structural adjustment program was accompanied by macroeconomic stability, which enabled response to the new policies. The fiscal deficit declined from 4.3% of GDP in 1984 to about balance in 1989. On the external front, the decline of world interest rates during a good part of the program and the improvement of the terms of trade in 1986–89 certainly helped the current account and economic growth.

The structural adjustment program was quite successful in the promotion of noncopper exports and the efficient substitution of imports. The combination of a competitive real exchange rate, low and flat tariffs, and specific fiscal incentives produced a strong response from nontraditional exports. At the same time, the generalized economic recovery strengthened substantially both the financial and nonfinancial sectors.

4.2.2 Income Distribution, Poverty, and the Military Regime's Economic Policy

The record in terms of income distribution during the authoritarian period points toward a deterioration, both during the restructuring process of the 1970s and through most of the structural adjustment process of the 1980s. This is not surprising, given the two sharp depressions that Chile experienced in this period and the painful adjustments that followed. In each case, real wages declined significantly and unemployment increased to unprecedented levels. Additionally, some of the economic measures adopted during these periods had a regressive bias.

It has been shown that the income of the poor is very accurately explained by the unemployment rate and the wage index. On the whole, wages in Chile declined more than per capita output, and unemployment was quite high on average.[2] It is likely, then, that income distribution worsened.

Several measures confirm this trend in income distribution. The Gini coefficient increased from around 0.50 in 1970 to more than 0.54 during 1982–84. The share in national income of the highest quintile increased steadily from 55.8% in 1970 to 59.5% in 1982–84, while the income share of the poorest two quintiles declined from 11.5% in 1970 to 10% in 1982–84. The worst point of income distribution happened, then, at the height of the depression (see table 4.3).[3] In 1989, however, the share of the bottom 40% had climbed back to 12.6%, while the top 20% had retained its 59.5% share; this suggests a recovery of income distribution in the second half of the 1980s.

A number of social expenditure items were severely affected by the adjustment to the economic and financial crisis, especially in the first half of the

2. The average rate of unemployment increased from 6.5% in the 1960s to 17.3% during 1974–89.

3. For a more detailed discussion on the distributive impact of the adjustment program carried out in the 1980s in the Chilean economy, see Larraín (1991b) and Meller (1991).

Table 4.3 Income Distribution in Chile: Selected Years, 1970–92

Years	Gini Coefficient of Family Income[a]	Share of Income[a] Lowest 40%	Middle 40%	Highest 20%	Real Wage Index[b] (1970=100)	Unemployment Rate[c] (%)
1970	0.500	11.5	32.7	55.8	100.0	5.7
1979–81	0.523	11.1	31.3	57.6	93.8	16.5
1982–84[d]	0.543	10.0	30.5	59.5	94.7	27.4
1989		12.6	27.9	59.5	97.6	6.3
1990		13.3	28.7	58.0	99.4	6.0
1991		14.7	30.6	54.7	104.3	6.5
1992[e]					109.0	4.9

Source: INE: Instituto Nacional de Estadisticas. Monthly report.
[a]Meller (1991).
[b]Central Bank of Chile. Monthly report.
[c]Cortázar and Marshall (1980).
[d]The share of income of different groups corresponds to 1982–83.
[e]Preliminary projections.

1980s. Thus, the per capita health, housing, and education budgets declined by more than 20% during the adjustment to the crisis of the 1980s.

The economic crisis and the policies directed to close the income-expenditure gap pushed the unemployment rate to over 30%—including emergency employment programs (PEM [*programa de empleo mínimo,* minimum employment program] and POJH [*programa de ocupación para obreros jefes de hogar,* employment program for heads of family])—in 1983, with unemployment remaining over 24% for almost four years (1982–85); real wages declined by 20% for at least five years, and minimum real wages dropped 40% during 1981–85.

Revenues of the public health system were also hurt with the privatization of middle- and high-income health care. When the option to switch to the private health institutions was given, 8% of the affiliates did so and carried with them 40% of the revenues of the public entity. While the reform certainly increased the quality of service for those who switched, the lower income groups suffered significantly from the decline in resources of the state system.

The military regime implemented several correct principles in the social sectors, such as targeting to the lower income groups, and decentralization and competition in the provision of social services. These principles found concrete application in successful programs such as free distribution of milk and attention to pregnant women, which influenced the sharp reduction in the country's infant mortality rate.[4] Nonetheless, this effort was not sufficient. A high

4. For a thorough—and favorable—analysis of social policies during the military government, see Castañeda (1990).

proportion of Chileans—estimated at around 45% by Torche (1987)—were living below the poverty level in the mid-1980s. Although poverty in Chile is not a new problem, this high proportion was, to a significant extent, the result of the 1982–83 depression and the adjustment pattern that followed. The economic recovery and the resumption of growth in 1986–88 improved this situation, but it takes decades of economic expansion to break the circle of poverty.

4.2.3 The Legacy of the Military Regime

It is widely recognized that the first democratically elected government after sixteen years of military rule in Chile inherited, in general terms, a very successful economy. This stands as a major contrast to other experiences of transition in the region.

At the end of the military government, the Chilean economy had been successful in completing its stabilization and structural adjustment. The country was a leader in the implementation of a number of economic reforms—trade and social security reforms and privatization, among others. The last half decade of the military regime was also the subperiod with better economic performance. During 1985–89, real GDP expanded at an average rate of 6.2%, inflation averaged 19.8%, the volume of exports expanded at an average annual rate of 10.5%, and the government was able to achieve a fiscal surplus of over 1% of GDP in 1989.

Nevertheless, as we just discussed, this success was not painless. The structural adjustment process carried out during this period resulted in significant costs. Available information is robust in pointing out a deterioration of income distribution during this period and the fact that the transition to democracy was initiated in the context of a high share of the population living in poverty.

By the end of the military regime, poverty had also become a very significant concern in public opinion. According to a September 1988 poll conducted by a prestigious private academic institution (Centro de Estudios Públicos, CEP), poverty and low income levels were the principal reasons behind the vote for the "no" option in the plebiscite of October 1988, which cleared the way for competitive presidential and congressional elections held in December 1989.

4.3 Economic Policies of the Aylwin Administration

The government of President Aylwin, a center-left coalition known as Concertación, was elected with an absolute majority in December 1989 and went into office in March 1990. The new administration started from a strong position on the economic front and maintained the economic model inherited from the previous regime. This produced a climate of stability in economic policy and institutions, necessary for strong private investment and sustained growth.

The democratic legitimization of the free-market economic model adopted by the previous regime was crucial. To attain this goal the government had to gain, in a short period of time, support for policy continuity from organized labor and from those that were hit worst during the prolonged adjustment process of the 1980s. Among the latter were those earning the minimum wage, which was, at the beginning of 1990, 35% lower than its real value for 1980; those receiving family allowances (which had not been adjusted since 1985), whose purchasing power in 1990 was a third of that in 1980; the average worker, whose real wage in 1989 was 1.6% lower than its average real wage in 1980–81; those receiving public sector pensions, which declined 10% in real terms from 1985 to early 1990; recipients of the subsidy for extremely poor families, which declined 50% in real terms between 1981 and 1989; and beneficiaries of social spending, which went down 20% in per capita terms since 1985. Clearly, the adjustment of the economy from the deep depression of 1982–83 had not been painless, but the economy was at the beginning of 1990 in a solid position to improve the situation of people.

The Aylwin administration was able to create a climate of consensus in the conduct of economic policy, which was central to shape the reforms that were implemented and to design the development strategy that was to be followed during this period. This strategy was built on four widely accepted principles. First, the market was to play the leading role in the allocation of resources and in the distribution of goods and services. Second, the maintenance of macroeconomic stability (building on fiscal austerity and monetary discipline) was crucial to ensure sustainable growth. Third, there was a commitment to increase social spending in health, housing, pensions, and education. Lastly, it was recognized that external markets provide the best opportunities for small economies, and thus the government must try to maintain a competitive real exchange rate and make efforts to increase the integration of the Chilean economy to the international markets in goods, services, and capital.

4.3.1 Macroeconomic Stability and the Management of Economic Policy

Managing Social Demands under Macroeconomic Equilibrium

The new democratic government faced several potential pressures from different groups of the population. An attempt to give in to all demands would have only produced short-term benefits at the cost of sacrificing macroeconomic stability and future growth. One need only witness the problems of Argentina, Brazil, and Peru in reconciling the different claims that arose with the restoration of democracy.

There was a wide agreement in the government and the opposition that the only way to allow a larger fraction of the population to benefit permanently from modernization, and to defeat poverty, was through sustained growth. But waiting for growth alone to eliminate poverty takes too long to be a viable solution ethically and politically. And growth does not necessarily come with improved income distribution in its earlier stages. If a large fraction of the population waits for years for the benefits of modernization, this process may be politically unsustainable in democracy. If perceived in this way by investors, such a postponement will ultimately limit, despite attractive fundamentals, the supply response to investment incentives until at least some of the uncertainty about the sustainability of pro-investment policies is resolved.[5]

Given the irreversible nature of productive real investment, stability and credibility in economic institutions and a solid basis of support for policy continuity may be more important to stimulate private investment than tax incentives and "high" ex ante rates of return. Put in other words, if there is a high degree of uncertainty in the economic-political environment, tax breaks and ex ante rates of return will have to be very attractive in order to have an important impact on the accumulation of physical capital (Dornbusch 1990; Pindyck 1991). Thus, an important cost associated with political and economic instability is its depressive impact on productive investment, and thus on economic growth.

The new administration avoided the conflict between macroeconomic stability and increased resources devoted to the lower-income groups in two ways: (1) changing the composition of government spending, whereas the share of social spending in the government budget during 1990–91 was 3.4 percentage points higher than in 1988–89;[6] and (2) implementing a tax reform that would contribute additional resources for social spending, as analyzed in section 4.3.2.

In addition, the government sent to Congress a labor reform in 1990, partly intended to balance negotiating power between employees and employers, and raised the minimum wage, the family allowance, and the subsidy for low-income families during 1990–92. These adjustments were set in national agreements among the government, the major representatives of organized labor (Central Unitaria de Trabajadores, CUT), and of entrepreneurs (Confederación de la Producción y el Comercio, CPC), which allowed for a 21.9% rise in the real minimum wage between March 1990 and March 1992.[7] In April 1991, the government, CPC, and CUT agreed that, after this first stage of recovery, further real increases in the minimum wage should be related to gains in labor productivity, and that future expected inflation (as opposed to past inflation) should be used as the criterion for nominal adjustments.

Although the minimum wage has a coverage of only 12% of the labor force and there are no mandatory wage changes, its adjustment serves as a "signal" of inflationary expectations for the rest of the economy. Thus, the use of future expected inflation to set the minimum wage, which was in fact the criterion used in the 1992 negotiations, is an important contribution to breaking index-

5. "Pessimistic" expectations may be self-fulfilling. The wait-and-see strategy deprives the economy of much needed investment, thus retarding growth and eroding the political support for policy continuity. Ultimately, this may bring about the reversal of pro-investment policies initially feared (Labán and Wolf 1993).

6. Some significant inflexibilities were built into the budget, such as the impossibility—by law—of reducing defense spending in real terms.

7. The minimum wage was in March 1992, however, still 12% below its average real value for 1980–81.

ation to past inflation (widely used in labor and financial contracts) and therefore inflationary inertia. The negotiations of public and minimum wages for 1993 were also based on expected inflation.

There was some room for wage improvement at the beginning of the democratic government, but it was necessary to be cautious in this area. Several important reasons suggested restraint from wage increases beyond productivity improvements. First, even though unemployment was significantly reduced during 1988–89, the economy hit productive capacity constraints; thus, to sustain low levels of unemployment, the required increase in investment put a strict limit on real wage adjustments beyond productivity improvements. Second, real wages recovered significantly in 1988 and 1989, increasing by an accumulated 8.5% over this two-year period. This was a clear indication of a tightening labor market, which through its own workings would further increase wages as long as the economic expansion continued. Third, there were doubts about the impact that the labor and tax reforms would have on the private sector and thus on the capacity of the economy to create enough productive employments. Some economists predicted that the combined effect of the rigidities that the labor reform would introduce, and the reduction of incentives to invest for firms that the tax reform would imply, would reduce the capacity of the economy to create productive employments and thus would result in a higher "equilibrium" level of unemployment.

The experience of other countries in Latin America helped Chile in this respect. Aggressive wage adjustments have proved short-lived and have quickly resulted in sharp wage contractions, as figure 4.2 shows for Argentina, Brazil, and Peru in the 1980s. In the first two cases, the rise lasted for just one year and then gave way to an enormous contraction that soon left workers with lower real wages than before the start of the expansion. In Peru, wages increased for two years and then suffered a major setback that left them substantially below their initial level in 1985. Thus it is in the collective interest of workers to avoid this pattern.[8]

During the first three years of President Aylwin's administration, average wages and the minimum wage are expected to grow approximately by 12% and 28% in real terms, respectively.[9] At the end of 1992, the unemployment rate is projected to be around 4.5%, almost 2 percentage points below that attained in 1989. At the same time, fiscal social spending rose an accumulated

8. Dornbusch (1989b) has argued that an artificial rise in real wages makes labor gain at the expense of capital. This has a negative impact on capital formation and may even induce capital flight. Thus the initial increase in real wages is partially dampened by a decline in the capital stock, so that the level of real wages that can be sustained in equilibrium may be lower than when this process started. For an analysis of the populist cycle, see Dornbusch and Edwards (1991) and Sachs (1990).

9. This rise in the average real wage is explained mainly by three elements: the increase in labor demand due to the expansion in economic activity, the decline in inflation, and the increase in real minimum wages.

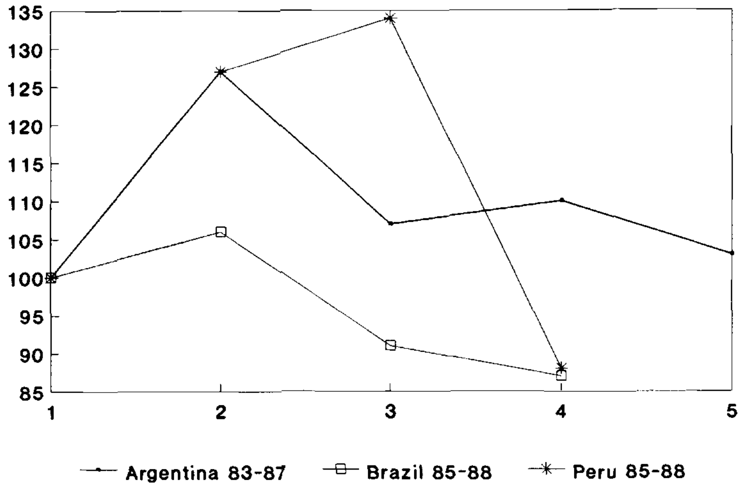

Fig. 4.2 Real wage index (year 1 = 100)
Source: Larrain 1991a.

20.5% real during 1990–91,[10] and it is expected to increase even further during the period 1992–93. Per capita fiscal social spending in the 1993 budget law is 40% higher in real terms than that stipulated in the 1990 budget law inherited from the military government. As agreed with CUT and CPC, the government has also implemented other measures directed to raise the income of poor families, such as increase in family allowances, subsidy to low-income families, payment of the 10.6% adjustment in the minimum pension that was not fulfilled in 1985, and wage rises to public sector teachers and health workers.

Higher wages and lower unemployment are bound to improve income distribution. Preliminary information suggests that income distribution improved during the first two and a half years of the Aylwin government. Estimates show that the income share of the richest 20% declined from 59.5% at the end of 1989 to 54.7% in 1991, which is the lowest level since 1970, while the lowest 40% of the population increased its share to 14.7%, the highest since 1970; the middle 40% of the families increased their share by 2.7 percentage points with respect to 1989. Nevertheless, there is still much to be done in Chile to improve income distribution and to reduce the still high share of the population living under the poverty line.

Cooperation with the government from organized labor, entrepreneurial associations, and the main opposition party (Renovación Nacional[11]) has been

10. This increase of public social spending can be decomposed into a 35.7% increase in health, 54.5% rise in housing, 8.2% increase in education, 21.6% rise in pensions, and 17.3% increase in other social items.

11. Renovación Nacional backed both the tax reform and the labor reform, as discussed below.

crucial in the preservation of macroeconomic stability and in the implementation of a social plan directed to integrate lower-income groups in a permanent way in the development process during the Aylwin administration.

Conducting Monetary Policy under High Capital Mobility

The new authorities thought that Chile could not sustain the high rates of GDP expansion it had experienced in 1988 (7.4%) and especially in 1989 (10%). They also considered the cumulative rates of expansion of private money (85%) and of domestic expenditure (23%) during 1988–89 to be unsustainable. This rapid expansion of aggregate demand had induced an increase in imports of 35% in value terms during 1989. In their view, the country was running the serious risk of an inflationary outburst.[12] The annualized rate of inflation reached 30% in the last quarter of 1989, and showed an upward trend. Nonetheless, the monthly indicator of economic activity (IMACEC)—a widely watched index in the country—showed that the economy was decelerating since the last quarter of 1989 (see table 4.4 and figure 4.3).

In early 1990, the Central Bank engineered a sharp monetary contraction aimed at reducing aggregate expenditure, and thus to moderate the rise of imports and to control inflation. Ex ante real interest rates on ten-year Central Bank bonds were raised from less than 7% in the last quarter of 1989 to 9.7% at the beginning of 1990. At the same time, the monetary authorities announced that the adjustment would be transitory, which indicated the prospect of substantial capital gains once interest rates declined to normal levels. Enthusiasm to acquire Central Bank bonds was immense, and the stock of Central Bank debt increased by 80% between December 1989 and December 1990. Attracted by high interest rates on long-term Central Bank bonds—which were offered through an open window—many funds invested on shorter-term instruments were shifted to longer-term instruments, and annual short-term real rates surged, from 6% at the beginning of 1989 to 13.3% in March 1990, their highest level since 1981.

The adjustment was vastly complicated by international capital mobility.[13] Spreads between local interest rates and international rates increased so sharply that short-term speculative capital flew massively to Chile. As a result, during the first half of 1990 the nominal exchange rate went from the upper limit of its 10% fluctuation band to the bottom of the band and remained there for the rest of the year. Moreover, the monetary authority had to purchase dollars in order to defend the floor of the band. As a result of this intervention in the foreign exchange market, the Central Bank ended up accumulating US$2.4 billion in reserves during 1990. To control the consequent rise in the monetary base, the bank sterilized the effects of foreign exchange operations by selling

12. According to estimates by Marfán (1992), any excess productive capacity generated during the prolonged adjustment process of the 1980s had been exhausted by 1989.

13. On capital mobility in Chile, see Labán and Larraín (1993).

Table 4.4 Macroeconomic Quarterly Data for Chile, 1989–92 (%)

Quarter	GDP Growth[a]	Inflation[a]	Unemployment[b]	Real Wages[a]
1989				
I	9.8	13.3	6.2	4.1
II	12.2	20.8	7.0	0.9
III	10.3	21.7	6.4	−0.4
IV	7.6	30.5	5.3	3.1
1990				
I	5.5	22.9	5.3	1.5
II	0.8	24.3	6.5	1.7
III	0.2	40.1	6.6	−0.7
IV	2.1	22.9	5.7	5.0
1991				
I	2.4	7.1	6.2	7.2
II	5.6	27.7	6.8	4.1
III	6.2	18.8	7.5	6.6
IV	9.9	22.1	5.3	2.6
1992				
I	8.9	4.8	5.0	3.2
II	8.2	13.0	4.9	5.8
III	13.8	21.3	5.3	4.4
IV[c]	8.1	12.5	4.4	3.9

Source: Central Bank of Chile.
[a]Average twelve-month rate of growth.
[b]Quarterly average.
[c]Preliminary projections.

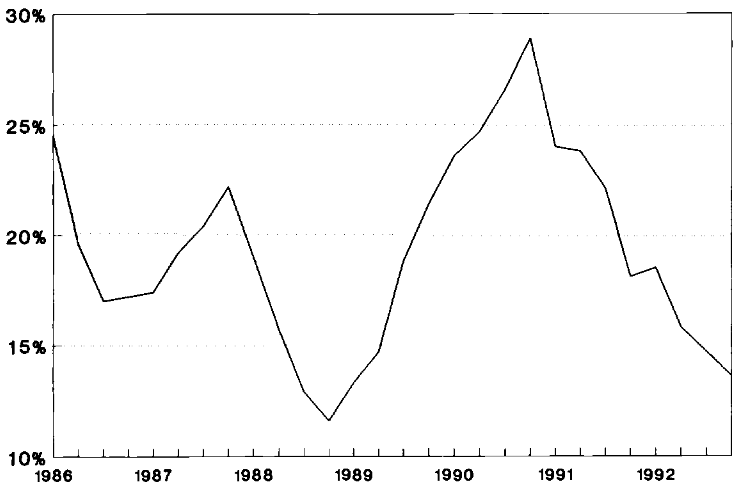

Fig. 4.3 Quarterly inflation, 1986–92
Source: Central Bank of Chile, monthly and quarterly reports.

more of its own bonds, preventing in this way a faster decline in interest rates. As a consequence, its balance sheet deteriorated: foreign exchange earned international interest rates, while Central Bank bonds paid a much higher peso rate.

The adjustment was costly in terms of output—GDP growth in 1990 was only 2.1%—but it served the monetary authority as a genuine proof that it was willing to pay a cost to fight what was regarded as an overheated economy, and thus to preserve macroeconomic equilibrium. Its contractionary effects, however, were milder on other variables and were soon reversed. The unemployment rate went from an average 6.2% during 1990–91 to an expected 4.8% by the end of 1992; real wages increased an accumulated 6.8% during 1990–91, and are expected to increase by 4.5% in 1992. An important increase in social spending and other government programs directed to lower-income groups also helped to mitigate the costs of the adjustment.

Fiscal Policy

Fiscal policy during the current government has been highly responsible, especially if compared to other transitions to democracy in the region. The government has spent no more than its income, generating a surplus in the consolidated nonfinancial public sector. Real government spending, however, increased at rates higher than GDP growth in 1991 (13.5%), while in 1992 it is expected to increase at a rate similar to GDP. Although the budgets approved by Congress have contemplated more moderate expansions, higher-than-projected revenues have enabled the government to spend more than budgeted without going into deficit.

Fiscal revenue has increased significantly during 1990–92, due to the tax reform of 1990, a strong expansion of economic activity and imports, a relatively high price of copper, and a reduction in tax evasion. In addition to low international interest rates, this has allowed the government to increase its social spending while generating enough saving to finance its investment and have a surplus in each of these three years. For 1990–91, the nonfinancial public sector attained an average surplus of 1.5% of GDP—3.1% of GDP if we add the copper stabilization fund. Expectations for 1992 are that the nonfinancial public sector will show a surplus of more than 2% of GDP. At the same time, comparing the expected execution for 1992 and the budget law for 1990, social spending and central government investment will increase by 30% and 53% in real terms, respectively.[14]

At the same time, the increase in social spending has been accompanied by a higher saving effort by the government. Nonfinancial public sector saving, which was on average 4.5% of GDP in the 1980s, rose from 5.0% of GDP in 1990 to 5.9% in 1991; in the first semester of 1992 it showed an increase in

14. The 1993 budget law (currently in congressional discussion) stipulates a real increase of almost 18% in government investment and of 7.6% in social spending.

real terms with respect to the same semester of 1991. Private saving has also increased, reaching 12.8% of GDP on average in 1990–91, which is almost double the average for the 1980s—6.9% (see table 4.5).

Nevertheless, the public sector's contribution to national saving has been partially dampened by an operational deficit at the Central Bank, which was 3.9% of GDP on average during 1983–89. Originally, this resulted from the government's intervention to avoid massive bankruptcies during the crisis of the early 1980s. After declining year by year since 1986, this quasi-fiscal deficit reached 2.1% of GDP in 1990, as the Central Bank suffered important operational losses to defend its nominal exchange rate policy and prevent a faster appreciation of the real exchange rate. This quasi-fiscal deficit declined to 1.3% of GDP during 1991 and is expected to decline even further in 1992 (see table 4.5).

The current government has contributed to this reduction in the quasi-fiscal deficit. Since 1990, the Aylwin administration has made extraordinary prepayments of more than US$600 million to the Central Bank, and the 1993 budget stipulates a prepayment of US$135 million. This has allowed the government to increase the consolidated public sector surplus in a politically viable way (increasing expenditure through prepayments), because, given the social needs of the population, it is politically costly for the government to show a high nonfinancial public sector surplus.

The strength of Chile's public finances is in sharp contrast to the situation of other economies, both in the developed and developing world. Countries with different degrees of development and diverse economic policies, and with governments of different political orientation, are fighting to reduce public deficits. In many cases, they have to reduce significantly social spending and public investment, placing a high welfare cost on those with lower income and negatively affecting long-term growth prospects. Estimates for the principal

Table 4.5 **Saving and Investment in the Chilean Economy, 1980–92 (% of nominal GDP)**

		Saving				
Year	Investment	Foreign	Domestic	NFPS[a]	Central Bank	Private
1980–89[b]	16.9	7.0	9.9	5.3	−2.4	7.0
1990–91[b]	19.5	1.3	18.2	7.1	−1.7	12.8
1990	20.2	2.8	17.4	7.5	−2.1	12.0
1991	18.8	−0.2	19.0	6.6	−1.3	13.6
1992[c]	21.0	3.5	18.5			

Source: Central Bank of Chile, Ministry of Finance.

[a]NFPS = nonfinancial public sector (includes Banco del Estado, the only commercial bank owned by the Chilean government).

[b]Average.

[c]Preliminary projections.

industrialized countries (OECD 1992) indicate that they will have fiscal deficits averaging 3% of GDP in 1992, with the exception only of Japan, which has a surplus.[15] Developing countries (including eastern Europe and the ex-Soviet Union), on the other hand, are expected to attain an average deficit of more than 4% of GDP (International Monetary Fund 1992). This same pattern is observed across geographic locations in developing countries; in 1992, fiscal deficits, as a share of GDP, are expected to be 3.7% in Africa, 2.1% in Asia, 6.7% in Europe, 6.4% in the Middle East, and 1% in Latin America.

Macroeconomic Performance

Higher interest rates had significant real effects in the economy. GDP growth decelerated from 10% in 1989 to a mere 2.1% in 1990. Paradoxically, inflation increased to 27.3% in 1990. This was greatly influenced by the effects of the Gulf War, which were quickly passed through to consumers. After high inflation rates in September and October (between 3% and 5% per month), inflation slowed down in the last two months of 1990, and declined to 18.7% in 1991. It is expected to decline to about 13% during 1992 (see table 4.1). Official projections point to a further decline in 1993 (around 11%), but this looks quite hard to achieve.

The rate of fixed capital formation declined from 19.5% of GDP in 1990 to 18.2% in 1991, and then rebounded to around 20% in 1992.[16] The drop of investment in 1991 was quite moderate; in our view, it responded mostly to the monetary contraction of 1990, while the tax and labor reforms—implemented also in 1990—had little to do with it. The unemployment rate, after having dropped consistently in the second half of the 1980s from its heights of almost 30% in 1982, reached an average of 6.2% during 1990–91, and it will be below 5% by the end of 1992. At the same time, real wages have increased by an accumulated 6.8% during 1990–91, and they are expected to rise by about 4% during 1992 (see table 4.1).

During 1990–92, domestic saving will attain an average of 18.6% of GDP, the highest in the last three decades. Although a stronger saving effort is still needed, this helps to set the basis for sustainable long-term growth. In this period, domestic saving will finance—on average—more than 90% of domestic investment, compared to only 41.4% in the 1980s. This will help to reduce the vulnerability of the Chilean economy to external shocks, which traditionally have accounted for a large fraction of the fluctuation that has characterized the country's growth process.

The external accounts have been very strong too. During 1990–91, the balance of payments showed a surplus, expected to be repeated in 1992 and in

15. Without considering the significant surplus in the social security system, however, Japan's general government is also expected to have a deficit of around 3% of GDP in 1992.

16. The rate of capital formation in 1990 was the highest since 1981, when it also reached 19.5% of GDP.

1993. The 1990 surplus was explained mainly by a large capital account surplus due to both an important inflow of medium- and long-term capital in the form of credits and direct foreign investment,[17] and an inflow of short-term speculative capital attracted by an interest rate differential that more than compensated for devaluation expectations and any other source of risk. During 1991, Chile experienced a small current account surplus—0.2% of GDP—the first since 1976. This was explained by a large trade surplus of around US$1.5 billion (an increase of almost 20% with respect to 1990), despite a reduction in tariffs from 15% to 11% in June 1991 and a decline of almost 9% in the real exchange rate. Exports have continued to grow fast, accumulating an increase of 10.5% during 1990–91; noncopper exports rose by 19.7% over the same period. In real terms, exports of goods and services accumulated an increase of 21.6% during 1990–91, increasing the outward orientation of the Chilean economy. In 1991, exports accounted for 33% of GDP, compared to 23.6% and 29.4% in 1980 and 1989, respectively. Foreign exchange reserves stood at US$9 billion at the end of 1992, equivalent to over one-quarter of GDP, or almost twelve months of imports.[18]

4.3.2 The Tax Reform Package of 1990

The program of the Concertación government contemplated a tax reform that could increase available resources for social programs in education, health, housing, and nutrition. The government understood that running a fiscal deficit to finance these programs would endanger the much-prized macroeconomic stability. This could result in increased inflation that disproportionately hurts those with lower income, who receive an important part of their income in nominal terms and have far less access to inflation-proof assets. Higher inflation could also threaten national saving and investment and, in this way, the prospects for future growth and social welfare.

A large majority of the country shared the objective of helping the less well-off. A minority, however, considered that increasing taxes was not the appropriate way to attain this goal. An agreement between the government and the main opposition party, Renovación Nacional (RN), enabled the legislative approval of the tax reform law.

The tax package included, among other measures, a change in *corporate taxation,* whose tax base went from only distributed earnings to total earnings, as was the case until 1988. Its rate was increased from 10% to 15% for the period 1991–93. This increase in corporate taxation was explicitly said to be transitory in the tax reform project sent to Congress by the executive, as a result of a previous negotiation with RN.

17. Direct foreign investment amounted to US$1.1 billion in 1990, a 26% increase with respect to 1989 and a record high for the country. On average, direct foreign investment was in the order of 1.6% of GDP in the 1980s, compared with about 4.5% in 1990–91.

18. On the basis of projected 1992 imports.

Personal income taxes[19] were raised by narrowing the income tax brackets but without touching tax rates—the highest marginal rate continues to be 50%—and the *value-added tax* (VAT) was increased from 16% to 18% (VAT had been 20% during most of the military regime and was reduced to 16% only in 1988). Both of these tax increases were permanent in the government project; as a result of the negotiation in Congress, however, they were raised transitorily until 1994.

Additionally, the corporate tax base for "large" agricultural, transportation, and mining companies was changed from presumed income to effective income, leaving the option to chose among both tax bases for small companies in these activities.

It is estimated that the tax reform package raised fiscal revenue by some US$800 million annually, or almost 2.7% of 1991 GDP, and the government was committed to spend all these extra resources in social programs.

Critics argued that the tax reform would reduce investment, but evidence in this respect does not support their claim. A drop in investment from 20.2% of GDP in 1990 to 18.8% in 1991 can be mostly attributed to a lagged response to the contractionary monetary policy of 1990. As mentioned, investment is expected to reach a record level of over 21% of GDP in 1992.

In other countries, the corporate tax rate fluctuates between 20% and 50% and cannot be used as a credit against personal income taxes, as it is the case in Chile. Additionally, the majority of these countries do not offer preferential treatment for retained earnings. In some cases, such as Germany and Japan, the situation is just the opposite: retained earnings are taxed at a higher rate than distributed earnings, as a way to favor the intermediation of resources through capital markets.

Small and medium-sized companies, however, may have been hurt by the increased cost of using retained earnings to finance investment brought by the tax reform, because of their restricted access to financial markets. To offset part of this effect, the reform allowed firms to discount up to 2% of the value of *new* productive investment from their corporate tax base, as a way to stimulate investment independently of its financing. Its low rate (2%) and a maximum deduction of about US$16,000 of 1990, however, made the effect of this incentive quite marginal.

There are also good arguments for a positive effect of the tax reform on investment. First of all, the increase was quite moderate and still leaves Chile as one of the countries with the lowest rate of corporate taxation. Second, the government made a commitment not to pursue further tax increases during its tenure after this reform was approved. Third, increased spending in health, education, and nutrition is also a form of investment, as it will likely mean improved human capital over the medium to long term. And last, an increase

19. The so-called *global complementario* tax, whose base adds up personal income from all sources.

in social spending, if used efficiently, would allow a larger proportion of Chileans to feel the benefits of the economic model, thereby increasing the popular support for policy continuity, which is expected to have a positive impact on private investment.

Other critics argued that an increase in the VAT would raise inflation and thus would have a regressive social impact. The reform, however, did not have an important negative effect on inflation. It is true that the VAT has a proportionately greater effect on lower-income families who consume a higher share of their income, but to evaluate the impact of a higher VAT on the poor, one needs to take into account also the share of higher spending—which this tax increase allowed—transferred to these families.

More than a year before the programmed reduction of the different tax rates increased in 1990, an important debate arose between the government and the opposition concerning the convenience of maintaining the current tax rates. The government is in favor of maintaining the tax reform, arguing that it is not possible to sustain the pattern of public spending already committed (a large part of which is permanent) and at the same time reduce the tax rates in 1994 without generating a fiscal deficit. The opposition is in favor of reducing the tax rates, on the grounds that the expansion in economic activity over the last couple of years allows for a reduction in tax rates while maintaining the social spending effort and without generating a significant fiscal deficit.

4.3.3 Reforms to Labor Legislation

By the end of 1990, a broad agreement had been reached about the need to introduce changes in labor legislation. The government had two major goals with this reform. On the one hand, it aimed to balance negotiating power between employers and employees, which the authorities considered to be biased in favor of employers. On the other hand, the government wanted to legitimize the labor legislation.

As mentioned earlier, the labor reform implemented in 1979 was largely opposed by workers. Their main criticisms were that it (1) repressed labor unions,[20] (2) restricted collective bargaining, (3) biased the relative bargaining power against workers,[21] and (4) allowed for arbitrary dismissal—workers could be dismissed without expression of cause and without appeal—and for a low severance payment.

The reform that was finally approved by Congress represented an intermediate position between the old law and the original project of the executive, as the

20. During the 1980s, the unionization rate in Chile was only 11%, compared to 18% during 1965–70 and 29% during 1971–73. This rate is much higher in developed countries. In Denmark and Sweden, for example, this rate is around 85–89%; in Belgium, 70–7 9%; in the United Kingdom, 40–49%; in Germany, Italy, and Canada, 30–39%; in Japan, 20–29%; in the United States, France and Spain, 15–19% (Ramos and Bravo 1992).

21. This law established that strikes should have a maximum duration of sixty days. If the strike was not over after sixty days, the contracts of striking workers were automatically terminated, losing them not only their jobs but also their severance payments.

government had to negotiate it with the main opposition party. This negotiation helped to moderate the reform.

The labor reform eliminated the right of employers to fire workers with no expression of cause, but allowed a general cause of "needs of the company." Severance payments remained at one month of salary per year of work in the company, but the maximum was increased from five to eleven months[22] (there was no maximum in the original reform project) and workers could appeal in court. In case firing was declared unjustified by the courts, the severance payment had to be raised by 20%. Additionally, severance payments in case of firing from the seventh year on can now be substituted (by agreement of the parts) for an all-event payment; that is, severance can be paid if the worker is fired or if he or she quits.

The other reforms to the labor law applied to collective bargaining and unionization. Groups of nonunionized workers were allowed to participate in collective bargaining, and negotiations started to be allowed at the industry level only by common agreement between employers and employees. Before the reform, negotiations were allowed only at the firm level. The reform also eliminated the prohibition to form union associations, extended the objectives of union organizations, gave more protection to labor unions, and increased the financing of union activities. On the other hand, the new legislation eliminated the maximum of sixty days for strikes, leaving them without limit.

Critics said that the labor reform would increase strike activity, push up real wages beyond productivity, and maybe raise unemployment.[23] The evidence, however, points the other way. Days lost to strikes have declined since the reform, and the unemployment rate declined to around 4.5% by the end of 1992, the lowest in more than two decades. Also, initial real wage adjustments in collective bargaining processes have been moderate and declined from around 4% in 1990 to an average of 2.5% for the period January 1991 to September 1992 (see table 4.6).

4.3.4 Trade Policy and Integration to the World Economy[24]

Since the mid-1970s, Chile has pursued a strategy of global trade liberalization, aiming to integrate the country into the world economy without making any distinctions among countries or regions. This strategy has been immensely successful. Chile's trade has been greatly diversified, both in terms of the composition of exports and in terms of trading partners. Asia, Latin America, and North America now account each for about 20% of Chile's exports, and Europe for 30%. Copper, which accounted for almost 80% of Chile's exports in the

22. The idea was to give dismissed workers enough income to subsist during the average unemployment period (8 months); this is important because Chile lacks an unemployment insurance program.

23. José Piñera, for example, minister of labor during the military regime, stated that the labor reform meant "putting a loaded gun in the hand of unions."

24. For further details on this topic, see Larraín and Assael (1992).

Table 4.6 **Initial Real Wage Adjustments Agreed to in Collective Bargaining (%)**

Period	Labor Unions	Groups	Total
1990			
January–March	6.1	4.9	6.0
April–June	3.7	3.7	3.7
July–September	4.6	2.1	4.1
October–December	3.5	2.9	3.4
1991			
January–March	3.2	2.5	3.1
April–June	3.0	4.7	3.5
July–September	1.4	0.8	1.3
October–December	1.6	0.8	1.5
1992			
January–March	2.9	1.7	2.7
April–June	2.0	2.9	2.1
July–September	2.6	3.4	2.7

Source: Annual Report to Congress delivered by the President of the Central Bank of Chile.

early 1970s, is now down to less than 40% of total exports in spite of increased production from new private mines. Overall, exports have increased dramatically. From about 15% of GDP in 1965, exports are now over 35% of GDP, a ratio similar to that of South Korea. Chile is today the most open economy of Latin America. And the export sector has become the main engine of economic growth in the country.

In spite of this success, the country is now pursuing free trade agreements (FTAs) with several countries of the continent. An FTA has already been signed with Mexico, which establishes a gradual decline in bilateral tariffs to 0% in 1996, and an elimination of all nontariff barriers. Soon Chile is likely to sign similar agreements with Colombia and Venezuela, and it is second to Mexico in progress toward an FTA with the United States.

Chile has not abandoned the goal of global trade integration. In fact, the country's flat import tariff was unilaterally cut from 15% to 11% in June 1991; furthermore, there are no nontariff barriers. But the trade strategy has shifted emphasis toward bilateral agreements, provided that they do not result in increased barriers with the outside world.[25]

There are several reasons for the emphasis on FTAs. First, it responds to a worldwide phenomenon, the prospect of large trading blocks in Europe (and maybe in Asia), and to the U.S. Initiative for the Americans. Although it might not be optimal for a country like Chile to sign FTAs if other countries were not

25. This is one complicated aspect of MERCOSUR, which is a customs union (not an FTA) and has not yet agreed on its common external tariff.

following this strategy, it may be optimal to do so if the world is moving toward the formation of FTAs (Krugman 1991). Second, although global free trade is recognized as the first best, there is growing frustration with slow progress in the General Agreement on Tariffs and Trade (GATT) multilateral negotiations. Third, if a country intends to liberalize trade anyway, bilateral agreements are a way to obtain something in return, especially when starting from low tariff levels and no nontariff barriers. Nonetheless, FTAs must be understood as a complement, not a substitute, of trade integration with the world economy.

To deepen its integration in the world economy, Chile needs to gain increased market access, especially in developed countries. FTAs may cooperate in this task. The net welfare implications of bilateralism are ambiguous, and mainly depend on the characteristics of the integration partners and on the international context in which the FTA is carried out. The different costs and benefits of this type of strategy should be taken into account when choosing trading partners. A recent empirical evaluation of an FTA with the United States (Coeymans and Larraín 1992) shows important gains to Chile of such an agreement, especially on the investment front.

Chile is currently evaluating an important number of FTAs (with the United States, Venezuela, Costa Rica, Colombia, Uruguay, Ecuador, and Argentina, among others), but the country lacks a well-specified trade strategy vis-à-vis FTAs. This leads to excessive arbitrariness in the evaluation of such agreements and to increased uncertainty on the relative profitability of different productive activities, which could have a negative impact on investment and growth.

4.4 Investment, Saving, and the Needs for Sustained Growth

One of the central challenges for Chile is to consolidate a stable path of strong economic growth. A low and highly volatile growth rate has characterized the Chilean economy for many decades. The average growth rate was 4.9% in the 1960s, 2.5% in the 1970s, and 3.6% during the 1980s. And the country has suffered two major recessions (1975 and 1982–83) with output contractions of up to 15%. A major improvement has occurred since the mid-1980s, when the average expansion rate reached a record of 6% for the period 1985–92, the highest in the Latin American region over the same period.

Sustained growth is the only way to defeat poverty permanently. It is also the way to avoid destabilizing social conflict. Strong distributive pressures in a stagnant society are bound to prove explosive. Thus, redistributive policies can succeed beyond the short run only in a growing economy. Lower-income groups have suffered the most with the instability that has characterized Chile's growth process over the last two decades. The challenge then is to attain higher rates of economic growth and to reduce its volatility, which, to a large extent, has been associated with external shocks.

4.4.1 The Role of Investment and Saving

The Necessary Investment Effort

Higher economic growth over the medium term requires increased rates of accumulation of productive factors—both physical and human—and improved efficiency. This is not necessarily true in the short run, however. The country can rely on available unutilized capacity to expand production even with relatively low levels of investment, as happened in the second half of the 1980s. But this has a limit. When the utilization rate approaches capacity, strong economic expansions get translated into an acceleration of inflation (e.g., 1981 and 1989) unless accompanied by a stronger investment effort. And when the external constraint is the dominant restriction, an effort to grow faster in the short run leads to a balance-of-payments crisis (e.g., 1971).

Investment has recovered strongly since the mid-1980s (in 1983 it was barely enough to cover depreciation), and by 1992 it is expected to be around 21% of GDP, with capital formation projected at about 20% of GDP. It is clear to most analysts, however, that capacity utilization has reached its upper limits.[26] Moreover, Chile cannot expect to obtain the efficiency gains of structural transformation or the benefits of stabilization, because structural adjustment has been completed and the economy is already stable. The labor market is now quite tight, and unemployment declined to about 4.5% by the end of 1992, the lowest in two decades. Thus, investment has become a major constraint on growth.

If Chile wants to increase its output at a rate of 6% to 7% per year, it will be necessary to increase capital formation at between 24% and 25% of GDP, assuming that this is done very efficiently. A brief examination of various countries that experienced high growth in the 1970s and 1980s shows that their investment efforts are substantially higher than Chile's. To achieve average annual growth rates of almost 7% to 9% over the last two decades, Korea, Malaysia, Singapore, and Thailand had rates of capital formation between 25% and 40% of GDP.

Some people argue that the Chilean economy is so efficient that it can grow at 7% consistently with the current levels of investment. This is, on our view, overly optimistic. Average ICORs (incremental capital output ratios) in those four Asian countries have been between 2 in Thailand and 3.2 in Singapore. In the past, however, the efficiency of investment in Chile has been lower than this, and only in the last few years has efficiency improved markedly. Chile's average ICOR during 1985–91 was 2.4.[27] Using this, and a depreciation of between 7% and 8% of GDP, the country's fixed investment rate would need to be between 24% and 25% of GDP to grow at 6% to 7% per year. If Chile's

26. See, for example, Marfán (1992).

27. This period is favorable to use to calculate the ICOR, as it includes the recovery from a major recession.

investment efficiency reaches Korea's (ICOR = 2.1), fixed investment should be between 22.4% and 23.4% of GDP to attain the same goal.

Thus, the extra investment effort needed in Chile to grow at 6% to 7% annually on a consistent basis is around 4 points of GDP. In 1992, however, the economy grew at over 9% with fixed investment of almost 20% of GDP. The discussion above indicates that this performance cannot be sustained. This is the view of the authorities, too. The Central Bank's annual report to the Senate and the minister of finance states that, "in spite of a dynamic investment during 1992, it is not considered feasible for Chile to sustain growth rates of over 6% per year."[28] According to Marfán (1992), the national saving and investment observed in the last couple of years will allow for a sustainable annual expansion of productive capacity on the order of 5.5%.

To some people, aggregate numbers look a bit intangible, and it is perhaps useful to mention two areas where anybody living in Chile could feel a deficit of investment. One of them is productive infrastructure. The fiscal budget for 1992 stipulated a real increase of 18.9% for public investment in infrastructure, and the budgetary law for 1993, just sent to Congress, includes a similar increase in this area. The accumulated (stock) deficit in infrastructure, however, due to low levels of investment in the last decade, and the necessary (flow) effort required to sustain high rates of growth, makes the current effort of the government in this area insufficient. The government has opened the possibility for the private sector to invest in major infrastructure projects, and the reforms to capital markets (discussed below) will help this initiative, but private participation in this area is likely to be marginal.[29] Another area where a deficit of investment is clearly visible is the protection of the environment.

Without adequate incentives, the private sector would tend to underinvest in these two areas, and thus requires constant assistance from the government (direct investment and/or subsidies). At present, Chile does not have the right mechanisms to induce the private sector toward the level of investment that is socially optimum in these areas. It is necessary to design schemes that would promote private infrastructure investment, and that would induce the private sector to internalize the social costs (benefits) associated with the destruction (protection) of the environment.[30]

The increased overall investment effort is sizable and cannot be accomplished in one year. For more than a decade, the main obstacle to increased investment and economic growth in Chile was the foreign constraint. Today this is no longer the bottleneck to economic development, and the prospects

28. Banco Central de Chile, "Evolución de la Economiá en 1992 y Perspectivas para 1993," annual report to Congress delivered by the President, September 1992.

29. The magnitudes involved are huge, and the law restricts private investments to new projects where an alternative exists for the users.

30. The new concessions law allows the private sector to build and operate public works. Since its approval in mid-1992, however, there has not yet been one project in operation through this law. The first one—a major tunnel—is expected to be approved this December.

for sustained growth now rest on the country's capacity to increase productive investment. Nevertheless, the experience of Chile and other countries of the region in the early 1980s suggests that a massive and short-lived inflow of foreign capital induces strong real appreciations of the local currency and a deterioration of the trade balance. Given the need to preserve export dynamism and thus to maintain a competitive real exchange rate, foreign saving must be used prudently. Thus, the bulk of the required increase in saving will have to come from domestic savings.

National Saving and Foreign Saving

At present, Chile can finance sustainably a current account deficit of 3% to 4% of GDP, as an upper limit. This is consistent with expected medium- and long-term capital inflows, and with the experience of successful Asian economies following an outward-oriented economic strategy.[31] An attempt to go beyond this level, although possible to finance in the short term, would probably be unsustainable. On the one hand, it is unlikely that foreigners would be willing to finance such a current account gap over the medium to long term. On the other hand, it may threaten the expansion of the export sector, the engine of economic growth, because it would likely require an appreciation of the real exchange rate at a rate higher than what can be offset by productivity gains. If this happens, a negative impact on aggregate investment is almost certain, given the larger opportunities offered by world markets relative to domestic markets.

National saving has been chronically low in Chile, even more so than investment. This is the case whether one compares Chile with industrialized economies or with other middle-income countries. During the 1970s, and especially in the early 1980s, saving was clearly insufficient to finance domestic investment. The gap was translated into significant current account deficits, reaching a record of 14% of GDP in 1981. The recovery of saving from the lows of the 1982 depression has been impressive, and by 1991 gross national saving reached 19% of GDP. Yet in that year foreign saving was negative (there was a current account surplus). For 1992, gross national saving is expected to reach around 19.5%. If Chile is able to attract and digest foreign saving of about 3% of GDP, the extra national saving effort would be around 2.5 points of GDP. This would finance inventory accumulation assumed at 1% of GDP per year, and fixed investment of 24% of GDP that would allow the country to grow consistently at a rate of 6% to 7% per year.

Increased national saving has been the result of higher public and private saving. The nonfinancial public sector saving rate attained an average of 7.1% of GDP during 1990–91 compared to 5.3% in the 1980s. On the other hand, the private saving rate reached 12.8% during 1990–91, which almost doubles

31. Larraín and Vergara (1993) study the cases of Korea, Malaysia, and Thailand, where average current account deficits for the last two decades have been between 2% and 4% of GDP.

that for the 1980s (7.0%). At the same time the government has contributed to reduce the quasi-fiscal deficit of the Central Bank, as mentioned earlier, which is an important source of national dissaving.

It would be desirable to achieve a significant increase in public saving to support the national saving effort. But one could not count on it, given the significant pressures to expand social spending, and the commitments that the government has already made in this area. Thus, it is likely that the bulk of the extra saving effort would have to fall on the private sector.

Reforms to Domestic Capital Markets

A higher contribution of private saving to finance investment can be accomplished both by stimulating the private saving effort and by more efficient channeling of private saving to investment. Two of the major sources of domestic saving in Chile are pension funds and life insurance companies. As of March 1992, these institutional investors had accumulated resources of US$15 billion, about 45% of GDP, which are expected to grow to 100% of GDP by the end of the decade. To attain adequate profitability and low risk, a further diversification of their portfolio—now constrained by strict rules—is needed. This requires a larger number of eligible financial instruments (creating new ones and increasing eligibility among those available), which would also increase the availability of medium-term domestic financing for investment projects. This goal has been partially accomplished by allowing pension funds to invest in new projects, which was previously banned. Three months after having developed such a mechanism, some important mining and infrastructure projects that used to be financed with external borrowing are completing the necessary studies that will allow them to place US$200 million in bonds among local institutional investors.

On the other hand, the government will soon send to Congress a project aimed at the modernization and deepening of the Chilean financial system. Its goals are to diversify the investment portfolio of institutional investors, to improve the regulation of pension funds, to strengthen the autoregulation mechanisms in the capital market, and to develop new financial instruments to channel private saving to investment projects. It contemplates the creation of bonds and funds for project financing, mortgage-backed bonds for the financing of housing, and the development of other types of securitization.

Labor Markets, Export Incentives, and Other Constraints to Growth

The tightening of the labor market—especially of skilled labor—suggests that, in contrast to what has been traditionally the case in Chile, labor may become a binding constraint to economic growth, maybe even more restrictive than domestic and foreign saving.

Additionally, given the central role of exports in Chile's development strategy and the difficulties experienced over the last two years in maintaining the real exchange rate, further gains of international competitiveness in the export sector and efficient import substitution industries will have to come from increased productivity. At present, a major objective is to improve the technological content and increase the value added of Chile's export supply. A highly trained labor force will be essential for this.

Chile's educational system, however, does not appear suited to accomplish this goal. At present, it is not preparing the kind of workers the economy is demanding, which may help to explain why the youth unemployment rate is almost twice the average rate. Thus, a reform to the educational system, and more and better training programs to improve labor productivity, should be given more attention in the near future.[32]

4.4.2 Vulnerability of the Growth Rate to External Shocks

To attain sustainable growth, the Chilean economy would also need to reduce its vulnerability to external shocks in commodity and financial markets. Since the mid-1980s, progress has stepped up in this respect.

The traditional transmission mechanism of external shocks is a drop in the trade of goods (or, equivalently, in the terms of trade) and a surge in the service of external debt. Since 1985, Chile has reduced the absolute level and relative burden of the external debt. More recently, public foreign debt has declined quite rapidly, generating space for external borrowing by the private sector while continuing the reduction in the debt burden. In 1992, the external debt to GDP ratio will be around 46%, which is the lowest in the last ten years.[33] At the same time, foreign direct investment has grown substantially in recent years, reaching an average of nearly 4% of GDP in the 1990s. Precise measures of the stock of domestic capital in the hands of foreigners are unavailable, but the large capital gains in the stock market and the reinvestment of profits suggest that it has increased significantly. Although it is difficult to estimate total net Chilean liabilities with the rest of the world, their proportion of debt to equity has declined. And foreign investment appears to have better properties than foreign credits during the cycle (Larraín and Velasco 1990).

Nowadays, the contribution of foreign saving to financing Chilean investment is much smaller than in the past. While in the 1980s this source of saving accounted on average for over 40% of total investment, it accounted for only 1.3% of total saving in 1990–92.

Chile's vulnerability to external shocks has been further reduced by the significant increase in export diversification, both in terms of goods and in the destination markets. Noncopper shipments represented 37% and 54% of total exports in the 1970s and 1980s, respectively; they account today for 62% of exports. The geographic diversification of exports has also increased; trade with Asia, for example, has surged to 20% of total trade. Higher availability of

32. Increased labor productivity can also be attained by labor reallocation from less to more dynamic sectors.

33. This coefficient was 81% on average during the 1980s.

foreign reserves in the Central Bank also helps to cushion against external shocks. While these reserves allowed the financing of seven months of imports—on average—during the 1980s, in 1992 they represented a whole year of imports, or a quarter of GDP.

The lower vulnerability of the Chilean economy is evident from its vigorous behavior of the last two years, in an international context characterized by low growth and slow expansion of trade. While in the 1990–91 world trade expanded at an average rate of only 3.1%, Chile's total trade increased by 7.5%. And world income will have grown at an average rate of 1.2% in 1990–92, compared to 5.6% in Chile.

Chile has also increased its degree of integration to international financial markets, which also helps to reduce the vulnerability of the economy to external shocks. On the one hand, the international diversification of Chilean assets—for example, the investment abroad of pension funds allowed in 1991—should contribute to reduce the variability of returns, and thus the volatility of national income. At the same time, external borrowing allows smoothing the impact of transitory external shocks, distributing its impact over time and thus allowing for a more stable consumption path.

A tighter integration with world capital markets allows for a more efficient allocation of capital and for risk diversification, but it imposes new challenges for a small economy like Chile. Higher international capital mobility puts strict limits on short-term stabilization policy if the country wants to avoid large fluctuations in the real exchange rate.

How effective monetary and fiscal policy are in this context depends importantly on the prevailing exchange rate arrangement. The fact that fiscal policy is—at least in the short term—less flexible than monetary policy favors a flexible exchange rate. But the central role played by the export sector in Chile's development strategy and the fact that short-term excess exchange rate volatility can have permanent effects on the pattern of trade (Krugman 1987) and investment (Pindyck, 1991) favor the protection of tradables from short-term variability. Chile now follows a target zone system with amplitude of ±10%. To protect against real appreciation, the center of the exchange rate's fluctuation band is adjusted by the difference of domestic inflation and an estimate of external inflation. This arrangement results in partial effectiveness of both monetary and fiscal policy.

Chile, like several other Latin American economies, has experienced lately difficulties in managing domestic stabilization policy in a context of large capital mobility and extremely low international interest rates—inconsistent with internal equilibrium (Calvo et al. 1992). This has resulted in increased investment spending, deterioration of the trade balance, appreciation of the local currency and the stock market, accumulation of external reserves in order to prevent further currency appreciation, and a need for sterilization to avoid the inflationary impact of massive purchases of foreign reserves by the Central Bank. The last two policies have led to important losses at the Central Bank and the requirement of maintaining high real interest rates, which attract more capital.

In the last year the government has carried out a number of measures directed to increase the degree of autonomy in domestic economic policy. First, it has increased the width of the exchange rate band from ±5% to ±10%, thus buying more independence for monetary policy. Second, it has moved to peg the exchange rate to a basket of currencies that includes the U.S. dollar, the yen and the deutsche mark, rather than only to the U.S. dollar; this makes the relevant international mix of economic policy a combination of fiscal and monetary policy in Germany, the United States, and Japan, which results in a higher average international interest rate than the U.S. policy mix alone. Third, it has adopted taxes and reserve requirements to foreign credits, increasing the "relevant" international interest rate and thus allowing Chile to keep a domestic interest rate consistent with internal equilibrium.

4.5 Conclusions: Continuity, Change, and Future Challenges for the Chilean Economy

Chile's economic performance in democracy during the 1990s has been outstanding. The economy is in its ninth uninterrupted year of growth, unemployment is below 5% (the lowest in more than two decades), inflation has declined to less than 13%, and the external position of the country is extremely solid. These achievements have occurred during a transition from military rule to democracy, in an international environment of very low growth and depressed international trade.

Many reasons account for this success. The strong initial position of the economy at the end of the 1980s, with macroeconomic stability and a completed structural transformation, was no doubt a crucial asset. Another major factor is a broad political consensus on economic matters. Of course, good initial conditions and broad consensus are necessary but not sufficient conditions. Highly responsible and well-oriented conduct by the economic authorities also deserves much credit.

In the end, we found more continuity than change in the economic policies applied during the current regime. This is not meant as a criticism. The sensible thing was to preserve most of the economic policies of the previous regime, while significantly improving the social effort, thus legitimizing the free-market economic model. Therefore, we regard the tax and labor reforms as important, positive, and moderate policy changes.

Despite a very healthy economic outlook, however, there are still substantial challenges ahead for the country. The first one is the consolidation of a strong and stable economic growth path. Second is the elimination of poverty, a condition that still affects some 40% of the Chilean population. Succeeding in this goal will take time even with the best policies. But it clearly requires the preservation of strong economic growth, since eliminating poverty will be impossible in a stagnant or slowly growing economy. Reducing inflation to single-digit rates has also become a widely shared objective, and it is a feasible option within the next two years. A more ambitious goal of achieving world inflation rates looks feasible only in the medium term.

To maintain high rates of growth it is necessary to increase Chile's investment effort. Capital formation has been growing strongly since the mid-1980s, and in 1992 it is expected to reach around 20% of GDP. This is healthy, but still insufficient to maintain rates of output growth of 6% to 7% per year on a consistent basis. Higher investment can count on foreign saving, but this source faces limits. In 1992, Chile will run a current account deficit of about 1.5% of GDP, which will likely double in 1993. Foreign saving of up to 3% to 4% of GDP per year is sustainable in an economy such as Chile. Thus, higher investment would require more domestic saving. The country's national saving rate in 1991 was 19% of GDP, and in 1992 will likely rise a bit. It is necessary to increase it between 2 and 3 points to support investment rates of around 25% of GDP.

A new challenge for Chile is the preservation of the environment. The worst environmental problem is air pollution in Santiago, which has so far been approached with half measures like a circulation restriction for 20% of all vehicles during weekdays. (Since September 1992, however, new cars imported or sold in Chile must have a catalytic converter.) Industries in certain areas also have maximum emission standards for toxic wastes. A comprehensive solution to the problem of air pollution, however, is estimated to cost over half a billion dollars and so far has not been tried. The preservation of species has been approached with special laws that regulate fishing and the exploitation of forests and native woods. For the first time, comprehensive environmental legislation is about to be approved by Congress.

Another challenge for the country is deepening its integration into the world economy in trade of goods, services, and capital. To this end, the country unilaterally reduced import tariffs from 15% to 11% in 1991, and is studying a number of FTAs that may help Chile gain access to some important markets. Bilateral deals, however, should be viewed as a complement to global liberalization, as the ultimate goal is to integrate Chile with the world as a whole.

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