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STABILIZATION AND ADJUSTMENT
POLICIES AND PROGRAMMES

COUNTRY STUDY

10

CHILE

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STABILIZATION AND ADJUSTMENT POLICIES AND PROGRAMMES

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PREFACE BY THE DIRECTOR

This monograph is part of a series being published by WIDER on the experience of developing countries with stabilization and adjustment programmes in the 1970s and 1980s. Each study analyzes the package of policies implemented by a specific country; its relations with the IMF and World Bank; the effects of the policies on production, employment, the balance of payments and social welfare; and what other policies might have been followed instead.

The intention of the series is to assist developing countries to devise adjustment policies that would, while accomplishing desirable adjustment and growth objectives, simultaneously remain politically viable in the particular country settings studied.

For this purpose it was thought desirable to explore policy alternatives to the adjustment programmes being implemented. Built into the design of the series, therefore - and constituting indeed its special feature - is the requirement that each study include a 'counterfactual' exercise to illustrate the effects of alternative policies. Utilizing econometric models adapted or specifically developed for each country, the probable effects of alternative policy packages are estimated; the object was to see how far the balance-of-payments adjustment and growth goals of a particular programme might have been achieved at a possibly lower social cost with a different policy mix.

Each country study is written by an independent scholar and expert in the relevant country. First drafts of the studies in this series were discussed at the WIDER conference on stabilization and adjustment policies in developing countries which was held 19-22 August, 1986 in Helsinki. Each study has been reviewed by WIDER's research advisers for the project, Professors Gerry Helleiner and Lance Taylor, and revised substantively by the author as necessary; subsequent editing has been conducted under the overall supervision of Mr Robert Pringle, Senior Fellow, who serves also as editorial adviser on WIDER publications.

A companion volume by Professor Taylor summarizing the experience of the countries surveyed will draw broader implications for the theory and practice of stabilization and adjustment policies; this volume will be published by Oxford University Press. The individual country studies in this series will subsequently be grouped into separate volumes, also for eventual publication by Oxford University Press.

Lal Jayawardena
Director
March 1987

EXECUTIVE SUMMARY

Two factors make the Chilean experience of stabilization policies interesting. One is that probably no other government in Latin America (and perhaps also elsewhere) has been more diligent in pursuing liberal economic policies than the one which took power in Chile in 1973. Almost straightaway it set about reducing the role of the state in economic affairs, freeing business from controls and allowing more scope for market forces to allocate resources.

Secondly, throughout its period of responsibility the Chilean government has endeavoured to adhere closely to the IMF prescription in its conduct of stabilization policy. And, according to the numbers, with some apparent success, too, both in the 1970s when it succeeded the Allende government and in the 1980s in the aftermath of the second oil price shock. One might add that in 1985-86 Chile was one of the first recipients of a World Bank structural adjustment loan after the unveiling of the 'Baker plan' for international debt.

The tale, however, is not all success. Far from it. The authors point out that the government has not been consistent. It flinched from applying a 'market solution' when it was faced with a situation in 1981-82 of widespread internal indebtedness: instead of letting heavily-indebted companies go to the wall, they and their bankers were rescued by the public sector.

More fundamentally, the authors criticise the Chilean government for being in too much of a hurry and for being insensitive to the employment and social consequences of its actions. Restructuring takes time, especially when a current account deficit reflects, as in Chile, both structural weaknesses and 'fundamental disequilibria'. Restructuring requires the application of gradual policies and not the shock treatment which most Latin American countries, including Chile, have undergone. The authors conclude by arguing the case for the application of gradual, selective and stable policies with adequate external financing, due regard for employment promotion and, if necessary, selective (multi-tier) exchange rates.

I. INTRODUCTION

'Chile has met its commitments in spite of the difficult external conditions. I don't attend these meetings (with the banks' committee) but with Chile I am making an exception due to its high degree of compliance in spite of several changes of ministers.' (Comments by J. De Larrosiere, IMF managing director, quoted by El Mercurio, 23 July 1985, our translation.)

In considering the role of international financial institutions and adjustment policies in a country like Chile, two recent experiences are worth examining. The first occurred between 1974 and 1981: the second between 1982 and the present. The neo-conservative economic policies imposed by the military government throughout these two periods have been praised by the IMF and the World Bank and are a source of great controversy. After all Chile is probably one of the countries which have more closely followed IMF policy recommendations.

In this paper we examine the adjustment policies pursued in 1982-85. After reviewing the origins of the crisis, we analyse the adjustment process, the social actors and their role. We review the IMF and World Bank programmes and we conclude with an analysis of some of the policy issues which seem relevant for the future.

II. PRE-CRISIS PERIOD

1. A brief overview of 1974-81

The Chilean economy underwent ambitious experiments in domestic economic policies in 1974-81 as well as a process of inflation stabilization and structural adjustment. The latter meant not only changes in resource allocation but also restructuring basic economic and social institutions. Reforms embraced the labour market and labour relations, asset markets, government social policies, property ownership, etc. They marked a very radical departure from the past.

This section sketches these changes so as to set the background to the adjustment difficulties the Chilean economy has been facing since 1981.

(a) The stabilization record

Inflation had soared well into three figures when the military government took power in 1973. After a first stage of price deregulation, exchange rate devaluations and adjustments in public tariffs, the government in 1975 adopted an orthodox stabilization plan aimed at reducing inflation by shock treatment.

The severity of the strategy is shown in table 1. In one year the fiscal deficit, as a share of GDP, was reduced from 10.5 per cent to 2.6 per cent. Because of the stabilization plan and the adverse foreign shocks which occurred in 1975 GDP fell by about 13 per cent. Inflation remained particularly stubborn, however; it did not fall below the 100 per cent year level until 1977 when an orthodox programme focusing entirely on curbing nominal spending was complemented by supply-side measures. In particular, the exchange rate was revalued in June 1976 and March 1978.

The high sensitivity of inflation to the exchange rate as the degree of openness of the economy increased, in contrast to its substantial inertia in face of demand shocks, led the authorities to fix the nominal exchange rate in June 1979 in a final attempt to bring domestic inflation close to international levels. The convergence of domestic and international inflation rates occurred three years later, when the exchange rate was overvalued in real terms by more than 30 per cent. By then (mid 1982) Chile had to devalue.

(b) Privatization

One of the more explicit goals of the economic programme implemented after 1974 was to reduce government intervention and to increase the role of the private sector and of market forces in resource allocation and the growth process. At the end of 1973, more than 500 enterprises and banks were owned or 'intervened' by the state. By 1980 no more than 15 remained in the public sector: the rest had been privatized.

In agriculture 30 per cent of the land expropriated during the Allende and Frei governments had been returned to its former owners by 1979, and 35 per cent had been allocated in individual plots to peasants and small farmers with only a fraction of that having in turn been leased or sold by peasants to third parties.

Another change in ownership structure took place through the formation of economic conglomerates ('grupos económicos') which owned both firms and major banks and which had preferential access to foreign credit.

(c) Liberalization policies

Another important element of the government's long-term economic strategy was the removal of price controls, liberalization of interest rates and the financial intermediation process, 'deregulation' of labour markets and

the elimination of trade barriers. The idea was to shift the economy towards a laissez-faire system.

In commodities markets, liberalization involved the elimination of price controls and subsidies. In trade policy all non-tariff restrictions were lifted and the tariff structure modified: in the five years from 1974 tariff rates were reduced from an average of 90 per cent to a uniform ten per cent (the only exception being automobiles).

Deregulation of the domestic financial system was another element. Interest rate ceilings were removed and controls on portfolio composition and the credit operations of banks and 'financieras' were substantially loosened. In the case of international capital flows, the regulations were progressively eliminated. Global limits on borrowing were lifted in 1979, although restrictions on short-term capital inflows remained until late 1981.

In the labour market collective bargaining had not been allowed before 1979, strikes were forbidden, labour unions were severely restricted and their power curtailed. But in June 1979 a new labour law ('plan laboral'), was put into effect. This initially guaranteed 100 per cent wage indexation, restored on a limited basis collective bargaining at the level of the firm in the private sector (labour federations, the public sector and service unions, were excluded from collective bargaining). Restrictions on the dismissal of workers were reduced and other social benefits dismantled.

2. Origins of the crisis

Chile's external debt crisis was triggered by the familiar external shocks that comprised a sharp cutback in new lending, deteriorating terms of trade, and a drastic increase in world interest rates (table 2). The deterioration in Chile's terms of trade was the worst in Latin America (CEPAL, 1985). They dropped about 15 per cent

between 1979 and 1981 to a level about half as much as in 1970.

The crisis was to a large extent the result of domestic policies which had led to ever increasing current account deficits. By 1981 the deficit had soared to 15 per cent of GDP from 6.4 per cent in 1979 and an average 3.5 per cent in the 1960s and 1970s. This very large increase had as its counterpart neither a high investment rate (table 1, column 6) nor an expansion in government expenditure (table 1, column 7) but a reduction in private savings. This in turn had three main causes: the overvaluation of the exchange rate which raised real wages and consumption; the sharp increase in asset prices and perceived wealth; and the reduction in real incomes (resulting from the deterioration in the terms of trade and the increase in world interest rates) which was perceived as transitory. The nominal exchange rate was pegged to the dollar, inducing a real exchange rate appreciation of almost 30 per cent in those two years. Finally, stock market prices rose by more 50 per cent in real terms during the same period. Rising expectations reflected the fundamentals which determine asset prices but were also part of a speculative bubble which burst in 1982.¹

An overvalued exchange rate coupled with rising consumption, investment, output and employment appeared to some observers as yet another economic miracle. But this was to overlook the fact that several variables had not recovered to their levels of the early 1970s and that below the surface there were serious disequilibria. The enormous current account deficit was obviously one, but high unemployment (16 per cent in 1981), an expansion of output which concentrated almost exclusively on non-tradables and the investment shortfall which for more than a decade had been 25 per cent below its historical rate, were perhaps less known but were no less serious.²

Not only in the flow variables does one find determinants of the Chilean crisis; the stocks were also out of line. To see why one has to refer to the wide financial liberalization decreed in 1975 when banks were freed to determine interest rates and manage their portfolios immediately after they had been transferred back to the private sector. Most banks were acquired by financial speculators who used them to build large conglomerates.

The demand for credit by these conglomerates coupled with the restrictive monetary policy of those years³ helped to push bank interest rates to over 35 per cent in real terms. These rates, which were thought to be only temporary, in turn stimulated credit demand to avoid bankruptcy. Interest rates actually dropped in 1979-80 but only to around 15 per cent in real terms and they dramatically rose again in 1981. Optimism in the business community led to credit being raised not only to finance interest payments but also to finance new projects. Most banks contributed to this process of debt deepening for two reasons: the first was the strong competition for market share, a typical characteristic of periods prior to a financial crisis⁴; and the second was the fact that an important part of the lending was channelled to companies in the banks' conglomerate or 'economic groups'.

Finally, the government's optimism about the self-regulatory properties of a free financial market meant that prior to 1982 there was neither adequate regulation nor effective supervision of the banks. Table 3 shows the very large increase in GDP percentage terms in debts to financial institutions between 1976 and 1981. A significant proportion can be explained by the capitalization of interest payments which had reached expropriatory levels. Asset prices had accordingly increased several fold. Stock prices, for example, rose ten times in real terms between 1975 and 1980 (see table 3).

There was very little real counterpart to the increase in financial activity. It was mainly an inflation of the value of assets and liabilities which results from the capitalization of very high interest rates. Speculation also inflated the value of non-financial assets. Even so, the investment rate was nearly 25 per cent below the average of the 1960s.

The real magnitude of the stock disequilibria and financial mess did not reveal itself until the government intervened in the banking sector in 1983. It is now known that 24 per cent of bank loans could be characterized as non-performing assets as against the 2.3 per cent figure reported before the crisis. The two large private banks rescued by the government in 1983 had lost 6.3 times (Banco de Chile) and 5.1 times (Banco de Santiago) their capital. They had been responsible for one third of all bank loans. Twenty other banks not intervened but supported by the Central Bank, lost on average 1.6 times their capital. The big two had lent 18 per cent (Banco de Chile) and 49 per cent (Banco de Santiago) of their assets to companies controlled by their own conglomerates or economic groups.⁵

Not only were most banks technically bankrupt (negative net worth); so were a high proportion of heavily-indebted non-financial companies. Bankruptcies reached a record level in 1982, with failure an ever present possibility for many firms which did not topple over the brink. There was a crisis of property rights: excessive indebtedness left unclear who owned what.

III. ADJUSTMENT POLICIES: 1981-85

1. The erratic policies of 1982

In the second semester of 1981 and the first semester of 1982 emphasis was placed on reducing absorption through the so-called 'automatic-adjustment' mechanism (gold standard). The balance of payments deficit was used as the occasion to reduce the rate of growth in the money supply and raise interest rates. Prices of non-tradables would fall producing an improvement in competitiveness (Ministerio de Hacienda, 1981). The automatic reduction in absorption coming from the balance of payments was reinforced by contractionary fiscal measures imposed early in 1982.

Had domestic prices and wages been flexible enough, relative prices of tradables would have risen and the recovery in competitiveness would have cut the current account deficit. In fact inflation decelerated very slowly and, even though recession had been developing since the second semester of 1981 (Marcel and Meller, 1983), domestic inflation remained above world inflation and thus the real exchange rate was still appreciating until mid-1982. This tendency was reinforced by the strong appreciation of the dollar. The improvement in the current account thus came from a reduction in output.

Real interest rates climbed to more than 40 per cent a year in real terms, worsening firms' domestic indebtedness. Rates were pushed up by contractive financial policies, but most of the increase in real terms came from the partly unexpected deceleration in inflation which took place that year. The counter-inflationary success of the nominal peg in the exchange rate mechanism came too late and thus helped to make the financial crisis worse.

The lack of downward flexibility in home goods prices in response to lower output is not surprising if we consider experience with the gold standard in the 1930s (Marfàn,

1984). On the present occasion rigidity was reinforced by the widespread wage indexation which prevailed in the labour market until mid 1982. Downward flexibility had thus to be provided entirely by a fall in non-wage costs and profits.⁶

In terms of equation (1), the contraction of absorption was reflected in a sharp decline in the demand for, and therefore in the output of, non-traded goods which increased unemployment without improving the current account (CA).⁷ For CA to improve it required a cut in D_T or an expansion of Q_T .

$$(1) \quad CA = (Q_T - D_T) + P(O_N - D_N)$$

where Q_i = output of sector i (tradables (T) and non-tradables (N))

D_i = demand of sector i

P = price of non-tradables in terms of tradables

From June 1982 the government devalued several times, in all by almost 50 per cent in real terms during the second semester of that year. One shortcoming of this policy was that it came about through a very erratic process which dramatically increased uncertainty about future relative prices. In less than two months the economy experienced a fixed exchange rate, a clean float, a dirty float and finally a crawling peg. At the same time the government lifted exchange rate controls, inducing a huge and perfectly avoidable capital flight (on this issue see Arellano and Ramos, 1986.) The increase in the real exchange rate together with restrictive monetary and fiscal policies doubled the inflation rate while inducing a sharp recession. GDP fell that year by over 14 per cent (table 1).

2. Rescuing the debtors

To analyse the behaviour of assets and liabilities during this period we present the main entries in the balance sheets of financial institutions, the Central Bank

and the non-financial private sector. In the table below we show in brackets the level of the variables at the end of 1981 in billions of Chilean pesos or US dollars. The accounts are incomplete and do not balance because we show only the most relevant items.

Financial Institutions		Central Bank		Non-Financial Private Sector	
L(440)	D(429)	eR*(39 x 4.7)	C(40)	C(40)	L(440)
eL*(39 x 7.6)	C _B (12)	C _B (12)	R(48)	D(429)	eL*(39 x 7.6)
R(48)	eD* _P (39 x 6.7)	C _g (74)	eD* _B (39 x 1.6)	q K(n.a.)	W(n.a.)
		F (0)	B(30)	B(30)	

Where,

- L = financial institutions loans
- e = exchange rate
- L* = foreign loans and loans denominated in foreign currency
- R = bank reserves
- D = deposits
- R* = International Reserves
- C_B = Central Bank loans to financial institutions
- C_g = Central Bank loans to the government
- D_P = foreign debt owed by financial institutions
- D_B = foreign debt owed by the Central Bank
- C = currency
- B = bonds issued by the Central Bank
- K = private non-financial capital
- q = price of capital goods
- W = private wealth
- F = Treasury bonds transferred to the Central Bank to compensate losses

Note that by 1981 more than 40 per cent of the debts owed by the financial sector were denominated in US dollars. This became therefore an important element in exchange rate policy. Banks had intermediated nearly half the Chilean foreign debt. In contrast with other cases, almost no financial assets were denominated in foreign currency.

As previously mentioned, asset prices (q) had risen very fast which, together with the high interest rates of previous years, inflated deposits (D) and loans (L and L^*). The maturity of both deposits and loans was very short. Most deposits were at 30 days and most loans at less than one year.

In spite of the large increase in financial activity, the system remained very simple and, given its sources of growth, extremely vulnerable.

It is interesting to analyse the way in which the financial crisis and excessive indebtedness were handled. At first (1981-82) the government tried to apply a 'market solution' which meant that debtors would have to sell their assets and solve their problems that way. But right from the beginning the costs to banks in terms of loss of public confidence which this solution imposed resulted in many cases of central bank financial support and direct government intervention. The market solution did not fare well with debtors either. Because of the macroeconomic nature of the debt problem, debtors felt that an overall solution was necessary and they refused to liquidate their assets. The courts were unable to process and settle the numerous conflicts that arose between debtors and creditors. As payment difficulties became more general, an atmosphere favouring a 'political solution' was created by pressure from debtors.

There were several possible solutions, which can be categorized according to the way in which losses are distributed. In the market solution, the losses would be assumed first by debtors (shareholders, company owners), then by banks (its shareholders) and finally by depositors and financial asset holders. This is not necessarily so in a 'political solution' where, for example, bank debtors and shareholders could avoid all or part of their losses.

The following alternatives can be mentioned:

(i) Nominal interest rates set below inflation. This approach, which requires a rapid inflationary acceleration, imposes losses on the holders of financial assets, but its effectiveness is limited by the existence of alternative financial assets (indexed and foreign currency). It was not followed in the Chilean case because the government had defined inflation control as a fundamental economic policy objective.

A similar approach consists of altering the index governing indexed instruments. This may be applied both to the instruments readjusted according to an internal price index and to those set in foreign currency. In Chile it has been used to favour debtors but, up to now, it has not caused losses to holders of indexed financial assets.

(ii) An increase in bank interest spreads and discrimination between debtors according to their solvency. Banks finance losses by raising the cost of credit to solvent debtors. This has occurred to a certain degree but it has been limited by two factors. First, the magnitude of the losses makes it impossible for them to be absorbed only in this way. It has been estimated that - in the case of the government-intervened banks - this method would require a ten-year period and a spread of 11.7 per cent real on an annual basis.⁸ Moreover, sound banks which do not need to raise their spread would take the place of troubled banks in the market.

(iii) Foreign creditors. At the end of 1982, half of the financial system's loans had foreign credits as a counterpart which had been obtained by the banking system (US\$ 7,270 million, representing 42 per cent of the country's foreign debt). Part of the losses could thus have been absorbed by foreign creditors. This has not happened, not even in the case of debts of local banks which have been liquidated.⁹ On the contrary, foreign creditors have obtained state guarantees in return for renewing credits.

On the other hand, foreign creditors have suffered some losses in the cases of direct loans to Chilean companies.

(iv) Monetary reform. In this case the value of financial assets and liabilities is modified by law. In Chile this happened only to a small degree in the case of depositors in banks that were liquidated in 1983; they could withdraw only part of their deposits.

An alternative as drastic as this requires a large degree of political power.

(v) Financing by the Central Bank or Treasury: the public sector contributes with subsidies and/or credits. This has been the strategy followed in Chile by means of different mechanisms a massive contribution of resources and commitments assumed by the Central Bank. The main mechanisms have been contributions to the banking system (emergency loans, making legal standards more flexible, purchase of the 'overdue' portfolio by the Central Bank, foreign currency swaps, state guarantees for foreign credits, etc.) and to debtors ('preferential' dollar subsidized credit for the sale of real estate, waiving of fines and interest, special rescheduling arrangements for large economic groups, etc.)¹⁰

Most of the financing for these programmes has come from the Central Bank, which has expanded its loans to the financial system and the debtors. In terms of the above mentioned T accounts, C_B is expanded in order to compensate for banks' losses, the withdrawal of deposits and to allow the banks to give more support to their debtors. Table 4 shows the enormous increase in credits these programmes have required from the Central Bank: \$1,470 billion. This represents in real terms an increase of more than ten times and was equal to almost 50 per cent of GDP in 1985. In addition subsidies given to the debtors in foreign currency alone, until the end of 1985, amounted to US\$3,100 million (to pay D_p and L^* the debtors have been given a subsidized exchange rate which has been between 35 per cent and 15 per

cent below the exchange rate for trade purposes). The cost of this subsidy is equivalent to 30 per cent of GDP.

As of this date - as can be seen in table 4 - the resources transferred by the Central Bank have been financed by the Central Banks' foreign debt (\$808 billions) and by increased internal debt (\$1,782 billions).¹¹ Foreign debt and international reserve losses have reached US\$5,900 million in net terms, financing 50 per cent of the increased internal credit mentioned above.

At the beginning of the crisis the Central Bank had net international assets of over US\$3 billion and at the end of 1985 it had a net external debt of almost US\$2 billion. In the rescheduling of foreign debt, the Central Bank - or the public sector in general - has been the only agent able to obtain new loans. It did not need foreign exchange for itself, but transferred resources to foreign currency debtors via the mechanism described. A problem will arise for the Central Bank when it has to service foreign debt in amounts higher than the new credits it may obtain.

The rest of the financing has come from internal debt, which is mostly in banks' hands and to a lesser degree in the hands of the pension funds. The Central Bank has in a smaller degree also contracted debts with the non-financial public sector (\$258 billion).

In conclusion, the Central Bank has supported the debtors, without having to impose high internal costs in the short term because it has contracted internal and foreign debt. The problem of loss distribution has to a great extent been postponed. Even so, it should be noted that an important part of the losses has already been transferred to the fiscal sector. The Central Bank has received bonds from the Treasury (F) for \$860 billion (US\$4.7 billion) in order to absorb part of its losses. Fiscal policy in coming years will have to define the distribution of these losses. Moreover, since foreign debt has been sought and the Central

Bank does not 'produce' foreign exchange, payment of the foreign debt will create a double transfer problem: from the productive sector to the Central Bank and from the Central Bank abroad.

3. The social actors

The social actors considered relevant vary according to macroeconomic and political setting. We will identify separately those which do not share the same interests but which have the economic strength or political power to influence economic policies or the results of the economic process. We also distinguish social actors which are relevant at present and those that will have some significance in the future. We will refer to four social actors: unions, pobladores, foreign banks and domestic capitalists.

(a) Unions and 'pobladores'.

The 'working class' is divided into 'wage earners', represented by unionism, interested in the evolution of real wages and job stability,¹² and the unemployed and underemployed, represented by the 'pobladores', highly interested among other things in reducing the unemployment rate.

Is it in fact useful to distinguish between 'unions' and 'pobladores'? Do they not have common interests? When the economy faces no 'external constraint' it is possible, given Keynesian unemployment and for given margins, to increase simultaneously real wages and employment.¹³ This was the case in Chile from 1977 to 1981 when foreign lending was abundant. But when a crisis beckons and the external balance becomes a binding restraint, a trade-off arises between real wages and unemployment. In this situation 'unions' and 'pobladores' no longer share the same interests. Their interests conflict, unless they transfer this conflict to other social actors. To increase competitiveness without

reducing real wages 'margins' could be squeezed for example by a reduction in profits, interest rates, taxes or public sector tariffs. In the first two cases the conflict between 'unions' and 'pobladores' could be transferred to one between 'pobladores' and 'capitalists' or 'domestic financial asset holders', while in the others the conflict would be shifted to the public sector budget.

Not only are the interests of 'unions' and 'pobladores' no longer converging in the new macroeconomic situation but their relative importance and strength has also changed.¹⁴

The main features characterizing the situation facing unions in the ten years after 1973 have been the decline in numbers, the loss of an important part of their capacity to act on behalf of its affiliates, and the limitation of their role as an active participant in the national political system. This has been the result of several factors including the government's severely restrictive policy vis-a-vis unions and their leaders, heavy unemployment and de-industrialization, labour legislation which left workers unprotected and allowed only the limited expression of certain interests in the economic sphere, and the diffusion of ideological propaganda aimed at destroying the principles of collective solidarity and favouring an individualistic outlook.

Two sets of figures tell the story. Between 1973 and 1983 the unionized part of the labour force fell from 27 per cent to under 8 per cent, that is to less than a third of the previous level. Secondly, whereas in 1973 there were almost ten times more unionized than unemployed workers or 'pobladores', by 1983 the number of unemployed ('pobladores') was more than three times that of unionized workers.

In analyzing the impact of adjustment and stabilization policies on different social actors the distinction between 'unions' and 'pobladores' may prove useful. But in Chile we

have to recognize that both segments of the 'working class' have been unable to exert direct influence on the State under the present political regime. They could however play a very significant role in a democratic political setting, as in the past.

(b) Foreign banks and capitalists

Chile's authoritarian government is significantly influenced at present by the military, foreign banks and several segments of the capitalist classes.

Foreign banks and capitalists have been more interested in the consequences of government policies on the valuations of their assets and liabilities than on investment and growth. Foreign banks had lent to private companies and Chilean banks which technically went bankrupt. They successfully pressed for state warranties of the debts and government subsidies to debtors. New foreign lenders, like the IMF and the World Bank, have partially divergent interests from those of the more exposed institutions. They have tried to limit government subsidies to debtors as state commitments compete with the future service of their loans. Conditionality has thus included the gradual elimination of some government subsidies to debtors.

Domestic capitalists fall into different categories according to their net worth. First are the conglomerates or economic groups. They have exercised power over the government because of the large number of companies they control and their close relationship with public officials. Perhaps more relevant has been the link they had developed with foreign banks. This power has weakened significantly since the government intervened in the banks at the heart of each conglomerate. With intervention the government took control of the source of finance vital for the functioning of the conglomerate's members. At the same time the end of voluntary foreign lending gave the Central Bank control over access to external finance.

As most domestic capitalists were heavily indebted, their economic strength was low, giving the government, through its control of the financial system and subsidies to debtors, a tremendous power. State control over the private sector has been greater than under Allende's socialist reforms in 1970-73. The government has used this power to remain in office, despite the significant opposition it has faced.

The ability of debtors to obtain relief has been determined by their strategic characteristics and their political influence. The owners of means of transportation¹⁵ have for example obtained better terms in rescheduling their debts. The same is true for the private mass media - mainly newspapers - which received government financial support with so far unknown 'conditionality'.

4. IMF and World Bank policies

This section examines the stand-by and extended fund facility agreements signed with the IMF in 1983 and 1985 and the structural adjustment loan, made by the World Bank in 1985. The Chilean case is interesting since it shows a blend of short-term stabilization, framed within the terms of standard IMF packages, with one of the first attempts at 'structural adjustment' by the World Bank along the lines of the Baker Plan.

IMF I: The 1983-84 Stand-By Agreement.

This was the first time Chile had been to the Fund since June 1976. The stand-by agreement was negotiated in 1982 when the economy was suffering the full impact of adverse foreign shocks and domestic recession.¹⁶ The financing requested amounted to SDR 500 million and the approved programme contemplated the following policy goals:

1. A reduction in the current account deficit from 11 per cent of GDP in 1982 to 7 per cent in 1983 and 4-5 per cent

in 1984. To attain these targets a policy of maintaining a high real exchange rate would be pursued through mini-devaluations following a PPP rule. The Fund expected unification of the exchange rate system which by the end of 1982 embraced a preferential exchange rate for foreign debt servicing, an official rate for trade flows and a free market rate for capital transactions.

2. Inflation was expected to fall from a target 25 per cent rate in 1983 to 20 per cent in 1984. To accomplish this goal the programme contemplated nominal wage increases for the public sector being held below the projected rate of inflation. Wage settlements in the private sector were to be determined by collective bargaining or individual agreement. Explicit indexation mechanisms were ruled out for the private sector.

3. The monetary policy stance was to be determined by the credit requirements of the subsidised domestic financial system and the monetary counterpart of medium term borrowing from foreign banks. Monetary equilibrium would take place at positive real interest rates: ceilings on nominal interest rates as well as capital account controls were allowed but merely as transitory devices to improve the balance of payments.

4. The deficit for the non-financial public sector was to be close to 2 per cent of GDP in 1983 and to approach equilibrium in 1984. The GDP growth prospect was 4 per cent for 1983. As growth in 1983 was well below target and the unemployment rate rose by 20 per cent, the non-financial public sector deficit was revised upwards to 4.5 per cent of GDP 1984. The fiscal package also envisaged higher public investment to be financed by a rise in public utility tariffs and the postponement of a tax reform which sought to stimulate savings and investment by tax cuts on corporate incomes and interest earnings.

Table 5 summarises the performance of the economy under the IMF programme as measured by four quantitative indicators used by the Fund to appraise programme compliance. Two key macro targets - net international reserves and net domestic assets of the Central Bank - show that the economy was well off track in the first two quarters of 1983. Reserve losses in that period were over US\$1 billion and the stock of net domestic assets of the Central Bank was ten times above target.

Those developments were the direct result of the financial crisis of January 1983 when government intervention in the domestic banking system drew sizeable resources from the Central Bank.

This reduced confidence in the domestic financial system and triggered capital flight which was staunch only when government guaranteed previously unguaranteed external private financial sector debt and provided government insurance of domestic deposits.

In September 1983 the economy got back on course at least in terms of meeting IMF's quantitative performance indicators. But this was not the end of the story. The current account target was not met in 1984 (the payments deficit climbed to 11.2 per cent of GDP as against the targeted 4-5 per cent). For the two years together the close-to-6-per-cent target for the current account deficit was not achieved, mainly because of the shifts towards expansionary fiscal policies in 1984, plus the strong recovery in investment in that year (the terms of trade continued to be below trend).

The 1984 current account deficit was financed entirely by capital inflows, so as to make a quick recovery compatible (GDP grew 6.3 per cent that year) with compliance with the foreign reserve target set in the stand-by agreement.

In summary, even though the Chilean economy was, overall, satisfying the Fund's rather narrow performance criteria, signs of important disequilibria were appearing by the end of 1984 in the balance of payments current account and in both the goods and labour markets as indicated by a sizeable output gap and persistent unemployment. And all of this was happening in the context of an unresolved financial crisis.

IMF II: The Extended Fund Facility Agreement: 1985-87

The second programme agreed with the IMF, focused mainly on reducing the current account deficit over a period of three years and bringing public finances to equilibrium by 1987 in a context of moderate growth and a slowly declining inflation rate. It contemplated a drawing of SDR 700 million over three years, starting in 1985 and subject to the fulfilment of a set of quantitative performance criteria.

Besides the operational targets (see table 6) the agreement contained the following policy goals:

1. A reduction of the current account deficit, which had amounted to 11.2 per cent of GDP in 1984, to 4.5 per cent in 1987. The programme contemplated a policy of maintaining a high real exchange rate, pursued through a crawling-peg, subject to the occurrence of permanent adverse shocks in the terms of trade and the foreign real interest rate. Concerning commercial policy, the agreement envisaged a reduction in tariffs to a uniform 25 per cent rate by the first semester of 1986.

2. On the fiscal side the programme aimed at a balanced budget for the non-financial public sector by 1987, with deficits of 3.0-3.5 per cent in 1985 and 2.3 per cent in 1986.

3. Monetary policy was expected to accommodate growth and inflation prospects and produce a positive real interest rate. Credit requirements in the subsidised and intervened financial sector were to decline as transfers and subsidies were eliminated.

4. The wage policy stance continued to embrace partial wage indexation in the public sector and decentralized collective bargaining and individual agreements in the private sector.

Finally, the programme was to be consistent with inflation declining from 25 per cent in 1985 to 15 per cent in 1987 and with a GDP growth rate averaging 3-5 per cent in 1985-87.

In contrast with the first year of the stand-by, the degree of compliance with the extended fund facility agreement was considerably higher in 1985 (see Table 6). With a change of Minister of Finance taking place in February that year, a shift in short-term policy priorities became evident. Great emphasis was placed on correcting the current account deficit as well as the fiscal deficit as a requisite to resuming 'sound economic growth'. This new policy stance differed from the flirtation with expansionary Keynesian policies which had characterized macroeconomic policies in 1984.

The policy shift helped to improve the current account deficit by US\$ 700 million in 1985. But this was achieved by slowing the recovery in GDP and by a devaluation. GDP growth in 1985 was close to 2.5 per cent, compared with 6.3 per cent in 1984. And the 16.3 per cent rise in imports in 1984 was turned into a 10 per cent fall in 1985.

This classical recession-induced improvement in the external accounts was achieved by a reduction equilibrium to 1.5 per cent of GDP in the public sector deficit, a devaluation, and a policy of restraining nominal wage increases coupled with high public service prices.

The World Bank Structural Adjustment Loan

After that the extended fund facility programme began to operate and, as a background to the 1985-86 foreign debt negotiations, the Chilean government secured a structural adjustment loan from the World Bank. The loan was for US\$ 250 million to be repaid in 15 years, including three grace years at a variable interest rate. It was expected that a second loan of US\$ 300 million would be signed during the second semester of 1986.

The focus of the loan was on the medium term, in line with the idea of 'adjustment with growth' envisaged by the Baker plan. It addressed the following goals:

- The promotion and diversification of exports.
- An acceleration in the rate of capital formation, to raise the share of investment in GDP; and, to help reduce reliance on foreign savings, a substantial increase in domestic savings.
- A third goal was is financial rehabilitation, which meant solving the internal debt problem, strengthening the loan repayment performance of domestic firms, and recapitalizing intervened banks.
- A fourth goal was the promotion of employment, even though this appeared less likely to be achieved in the short run.

Implementation involved a 'new' conditionality, similar in spirit to that of IMF programmes. The performance criteria were however different. And the agreement provided for a wide variety of actions ranging from the creation of a copper price stabilization fund to World Bank approval of domestic banking system legislation (see report No. P-4131-CH, World Bank, page 34).

Let's review in more detail the programme's major goals.

1. Export promotion. This was to be pursued on several fronts. First, the exchange rate and tariff system was to be directed so as to provide high and stable profitability for export activities, in particular for non-copper exports. On the tariffs side low and uniform import tariffs were agreed. Secondly, to preclude real exchange rate variability associated with the volatility of copper prices, the programme provided for a 'copper stabilization fund'. The fund would operate through a budgetary mechanism whereby variations in copper prices above a pre-determined level would be sterilized in a reserve fund. This in turn would be used to smooth out shortfalls in copper revenues when prices fell below the official forecast. Thirdly, the programme envisaged a strengthening of Prochile, an export development agency, in its declared role of gaining foreign markets and supporting export-oriented domestic firms. Fourthly, the programme sought to direct private investment toward export activities.

2. Savings mobilization. The strategy contemplated a sharp increase in the share of investment in GDP, from close to 14 per cent in 1985 to 20 per cent in 1990. This would come mainly from the public sector. Government savings were projected to reach 4.5 per cent of GDP in 1986 - and the composition of public investment reflected priorities like the expansion of copper and infrastructure needed to overcome bottlenecks affecting export growth.

For private investment the programme placed confidence in the idea that 'right' and stable relative prices favouring exportables would enhance investment in those sectors, and that savings would result from tax incentives.

3. Financial rehabilitation. Great emphasis was placed on the need to solve the domestic indebtedness problem and to bolster the financial situation of solvent private firms, as a requisite for the export-led growth strategy.

The plan envisaged both institutional changes in domestic capital markets and a reduction in the government's role:

- A reduction in Central Bank subsidies to the banking system and the end of the massive rescheduling of domestic loans.
- World Bank approval of banking and corporate legislation, which in turn should strengthen the role of the Superintendencia de Valores in the supervision and control of corporate and bank operations.
- Recapitalization of most Chilean banks. The main element here was the sale of bank 'assets' to the Central Bank, thus removing bad loans from their balance sheets and making them profitable again. An extra twist was the public sale of shares in 'cleaned' intervened banks and the private pension funds owned by those banks. The government heavily subsidised the sale of shares.
- Finally, the World Bank would set up a small financial restructuring loan to help the Central Bank sort out solvent firms and to provide them some extra financial and managerial assistance.

4. Employment generation. The World Bank loan recognized that the growth prospects underpinning the programme would not allow for a substantial reduction in unemployment. This problem was to be tackled by maintaining wage de-indexation and other labour market 'flexibilization' policies, together with government-supported employment emergency programmes like PEM and POJII.

5. The relevance of IMF/World Bank policies

(a) Types of deficits

Before analyzing the IMF/World Bank policies as applied

in Chile, it may be useful to recall the IMF's traditional classification of deficits, each of which is associated with an appropriate policy response (Williamson, 1983).

Temporary deficits are caused by climatic factors or cyclical variations in the terms of trade or in foreign demand and can be expected to reverse themselves automatically without adjustment action. They should just be financed.

In contrast three types of deficits require the application of adjustment policies: excess demand deficits, fundamental disequilibria and structural deficits.

Deficits caused by excess demand can in principle be corrected by expenditure-reducing policies without increasing unemployment or underemployment. According to equation (1), the current account deficit could be corrected by a reduction of the demand of tradable (D_T) and non-tradable goods (D_N). Since we assume an initial excess of demand in the non-traded goods sector, this contraction need not produce a drop in output (Q_N).

Fundamental disequilibria are defined as deficits which would persist over a cycle, even in the absence of excess demand. The standard IMF policy prescription includes devaluation to improve competitiveness and to produce a shift in the composition of the demand. The IMF typically reinforces this policy with demand restraint to contain the expected expansionary effects of devaluation on aggregate demand. In contrast to this presumption, the fact is that devaluations have normally produced in Latin America short-run contractionary effects (Taylor (1983), Solimano (1986)).

Finally, a structural balance-of-payments deficit has been defined by Williamson (1983) as where 'domestic output of tradable goods is already as high as capacity permits and the economy lacks the elasticity for short-run substitution between tradables and non-tradables in production or

consumption, ... (so that) price signals alone are not sufficient'.

Both the 1983-84 stand-by agreement and the 1985-87 extended fund facility agreement share the main characteristics of the IMF policies prevalent throughout Latin America: credit restrictions, fiscal retrenchment and sharp devaluations.

At the end of 1981 the Chilean current account deficit was a combination of a fundamental disequilibria and a structural deficit. The structural component arose from the fact that insufficient investment during the previous decade required considerable unemployment if the current account was to be balanced.

IMF-type policies address the fundamental disequilibria problem by re-directing the economy towards attaining external balance at the cost of reducing output and wages and increasing unemployment and inflation. After reaching external balance significant reductions in unemployment can be attained, if the other parameters do not change, only at the cost of even sharper devaluations and thus an even further decline in real wages and increase in inflation.

Several estimates of the elasticities of the trade accounts have been produced for the Chilean economy (De Gregorio, 1984). They indicate that in 1983 each point reduction in the rate of unemployment would require a drop in real wages of more than two percentage points.

Even though, as we argued earlier, the government was almost totally deaf to the demands of unions, it was certainly difficult to continue reducing real wages when by the end of 1983 they were already almost 15 per cent below their 1970 level.

The presence of a structural deficit in addition to fundamental disequilibria impedes IMF-type policies to

attain external and internal balances simultaneously. Restrictive monetary and fiscal policies produced moreover a sharp drop in the investment rate from 19.5 per cent in 1981 to 12.9 per cent in 1983. Public investment was reduced as a consequence of the cut in the budget while private investment was curtailed by high real interest rates and the recession. Private investment was further reduced by the financial crisis. As we have seen above, the crisis eroded property rights. Poorly defined property rights obviously do not favour private investment.

Reductions in the rate of growth of the capital stock tend to make the structural deficit worse. A contradiction thus tends to appear when an external crisis comes from a mix of fundamental and structural deficits. IMF policies oriented towards solving the first tend to worsen the second.

In a way the World Bank structural adjustment plans described above are geared towards some of these objectives and, in particular, towards increasing the capital stock in the tradable goods sector, especially for exports. Even though public investment is to be stepped up, in the private sector emphasis has continued to be placed almost exclusively on trying to attain the 'right relative prices'.

To attain internal and external balance we need to increase the capital stock (in the tradable goods sector), reduce non-wage returns or increase productivity. Commercial policies which exploit the use of price incentives for more flexible and elastic sectors could help to restore equilibrium. But, given the large disequilibria in the Chilean case, employment policies such as subsidies and government make-work programmes will be required to achieve full employment and external equilibrium.

(b) Financing versus adjustment

A gradual adjustment like the one required in Chile's circumstances required more financing than the amount

available. Table 7 shows that Chile, as most Latin American countries, has had to make a significant transfer of resources abroad because of insufficient finance. In 1982-83 the adjustment was partly attenuated by drawing on international reserves. But in 1983 and 1985-86 the surplus in the non-financial current account was equivalent to a reduction of more than 17 per cent in imports or more than a fifth in investment. More financing, and therefore a smaller trade surplus, would have allowed greater import capacity and hence, given the foreign exchange constraint, higher output. Alternatively, a smaller trade surplus could translate into more investment.

Private foreign banks have collected even larger resources. This has been made possible by the relatively large new lending provided by multilateral institutions (IMF, World Bank, IDB). Chile made use of a virtual reserve fund resulting from the small debt it owed to these institutions. The Fund and the Bank seem highly interested in rescuing an 'economic model' which they have strongly supported in previous years.

(c) IMF/World Bank external sector projections

Another characteristic of both the IMF and the World Bank programmes has been their optimism about the size of the trade surplus which could be achieved. This optimism particularly applied to export growth: the programmes gave much more emphasis to the role of export promotion compared with import substitution in the adjustment process.

Table 8 shows IMF and World Bank projections of the external sector accounts made at different times between 1982 and 1986. When the first IMF programme was signed (December 1982), a very large and rapid improvement in the trade and current accounts was projected. Those balances have not yet been attained and are currently being projected for 1987-88. They might thus be reached three to four years later than projected.

The lag in export revenue is even more striking. The total is still below the level reached before the IMF programme started in 1982. This reflects a large and unanticipated drop in export prices: export volumes have grown at the rate projected. Table 9 records the large fall in export prices. If export prices are deflated by the price of imported inputs,¹⁷ the drop in real terms between 1980 and 1985 is about 20 per cent. Most of this had occurred by 1982 since there was little further deterioration thereafter.

An area that requires further research is the extent to which Chilean terms of trade may have deteriorated because of the expansion of export volume.

Another crucial element in external sector projections is import-output elasticity. The IMF and World Bank considered an elasticity close to unity. This seems rather optimistic if one considers econometric evidence based on time series. Those estimates find short-run income elasticities between 1.5 and 2.0 (De Gregorio, 1984). Whether a policy of maintaining a high real exchange rate will itself be enough to reduce the size of this elasticity remains an open question.

On the whole IMF/World Bank projections reflect an assumption that it is easy to adjust external accounts. At least, things are assumed to be easier than seems to be the case with structural deficits like the Chilean.

IV. POLICY ISSUES

Several policy implications can be drawn from this analysis.

1. Hysteresis in practice

Traditional economic models use comparative static analysis. They thus disregard the consequences of being in disequilibrium. The inadequacy of this approach has been recognized recently as a result of the persistence of certain disequilibria in North America. In Latin America this inadequacy has long been accepted in the structuralist approach, perhaps because of Latin America's more frequent macro disequilibria.

The Chilean experience provides a vivid example of how prolonged disequilibria build up into a new situation with lasting consequences. The overvaluation of the Chilean peso which took place between 1978 and 1981 as an anti-inflation device reduced international competitiveness and stimulated a large foreign capital inflow. The debt-export ratio climbed from 2.8 in 1978 to 4.6 in 1982.

The malfunctioning of the financial markets reflected in high interest rates and the accumulation of debt pushed a large number of producers into a state of over-indebtedness and the brink of bankruptcy.

Two deep recessions (in 1975 and 1982-83) in less than a decade and low investment rates have created a serious structural unemployment problem. Correcting this will occupy much Chilean economic policy-making in the coming years. The cost of correcting past disequilibria turned out to be extremely high.

2. Financing and speed of adjustment

The transfer of resources out of Chile will increase in

the future unless more finance is provided (table 7). This outlook should be modified for at least two reasons. First, given the fact that the Chilean current account deficit is of a 'structural' nature, the only way to attain external and internal balance is through a change in the level of investment and composition of output. As we argued above, restructuring takes time. It requires the application of gradual policies and not the shock treatments which most Latin American countries, including Chile, have received. Consequently, finance is needed to avoid recessions which reduce investment and so curtail possibilities of structural adjustment in the medium run.

The second reason is that by 1982 two-thirds of Chilean external debt was private. From 1983 onwards the government has been forced by the crisis to give an a-posteriori state guarantee to outstanding debt. Because of this and a general lack of bargaining power, the country has been unable, as most of Latin America, to share the losses of the crisis with foreign private banks. Indeed Chile, as most of Latin America, has been a net exporter of capital in past years. Should not this give Latin American countries a strong bargaining position vis-a-vis private banks? Coordination efforts with other debtor nations should be pursued. That is the only way to surmount the present 'prisoner's dilemma' which has produced such a passive and docile bargaining strategy on the part of Latin America (O'Donnell, 1985).

The need for more finance may be partly satisfied if the present improvement in the terms of trade, characterized by a drop in world interest rates and oil prices, tend to last. Both have meant about US\$ 250 million more being available for 1986, which would allow a 7.5 per cent increase in imports. This recovery, in the still seriously depressed terms of trade, should not be translated into larger resource transfers to the banks. On the contrary, it provides an opportunity for a recovery in domestic output and investment. This extra import capacity would make possible an additional GDP expansion of about 5 per cent.

Even after receiving more adequate external finance, the foreign exchange constraint will remain in a country like Chile, where external debt amounts to 1.2 times GDP and a very low fraction of the debt was used for investment. In these circumstances a way has to be found to reconcile adjustment with growth and provide a more equitable distribution of the costs involved. 'Selective policies' seem an alternative. At the same time, as excess capacity is used up investment will become more pressing. We analyse these two issues below.

3. Selectivity in short-run policies

A general devaluation has been the most frequent policy option to alleviate an external constraint and permit an expansion of aggregate demand to reduce unemployment. When devaluation is accompanied by adequate demand management policies, unemployment falls without again making the current account worse. Real wages fall and inflation normally accelerates.

Without denying the need for a devaluation particularly when, as in Chile, overvaluation was one of the causes of the disequilibria, we argue that it should be complemented with other policies. One way to reduce the negative results of a devaluation is in the application of 'commercial policies'. These policies could make the current account target comparable with a higher level of employment.¹⁸

One set of 'commercial policies' rarely backed by the IMF are what we could call 'selective policies'. In the short run the elasticity of the supply of exports differs significantly from sector to sector. The same is true about the demand for imports. Why not try transitory differential devaluations between sectors as suggested for example by Schydrowsky (1982) and Ramos (1985)?¹⁹ Even though the usual arguments against discrimination and interventionism apply, they rest only on efficiency arguments which relate to the allocation of fully-employed resources.

The distributive impact of a devaluation, which takes place through a decline in wages and in its impact on assets and liabilities, is a strong argument in favour of selectivity. The same is true when we consider price stability as yet another objective of economic policy.

Additionally, to deal with 'structural' unemployment, 'employment policies' should be considered. Again the issue is selectivity. How can we discriminate between sectors so as to improve the 'employment-intensity' of total output? We assume that there is not much to be gained, at least in the short run, from factor substitution for the same output structure. Given the magnitude of unemployment resulting from the external constraint and its structural element, attempts have to be developed to shift the composition of private sector output by government make-work programmes (Cortázar, 1983; Meller and Solimano, 1984).

To summarise, the pretension of trying to design 'first best' policies needs to be abandoned so as to be able to design a combination of reinforcing sectoral incentives based on the impact of the composition of output on the foreign sector and on employment levels.

These arguments point towards the design of gradual, selective and stable policies, geared in the medium run towards surmounting the 'structural disequilibria' which at present characterize the Chilean economy.

Such policies differ from the IMF-type of adjustment policy with its typical 'homogenous policy shock' or the more recent World Bank policies which, even though suggesting a more gradual adjustment, do not provide enough finance and continue to press in favour of homogenous policies. These policies are characterized as 3 and 4 in table 10.

Our proposal for gradual and selective policies is characterized by 1 in table 10. For these policies to be applied more financing is required. If this should not be

forthcoming, the choice should be selective and shock policies (position 2 in table 10). Even though these are clearly inferior to the gradual kind, they would still reduce economic and social costs, as compared with the typical homogeneous-shock policies of the IMF.

4. Structural adjustment and investment

Structural adjustment raises several investment policy issues. The first is the question of the savings to finance investment. Table 11 shows government projections for the rest of this decade. The planned increase in investment to an average of 18.5 per cent of GDP in 1986-90 is probably insufficient to reach the projected rate of 5 per cent GDP annual growth if one considers the higher than 5.0 incremental capital output ratio observed in the past. But even this less-than-satisfactory investment rate and a rather optimistic growth response to it translates into a stagnant level of per capita consumption. At the end of this decade per capita consumption would be more than 10 per cent below the 1980 level and more than 12.5 per cent below the 1970 figure.

Again we see here the crucial importance of the resource transfer to foreign banks. Note particularly the effort projected for 1986-88, and the need for additional finance (table 7).

If in almost any scenario average consumption is not expected to reach its historical levels during the coming years, then the issue of its distribution becomes of first importance. From this viewpoint we analyze the likely result of two sets of recently-implemented policies. In 1984 a generous tax relief to stimulate private savings was introduced. The reform is reducing government revenues equivalent to about 2 per cent of GDP with dubious success in raising private savings (Marfán, 1984a).

This kind of policy to stimulate savings is quite

different from those proposed by structuralists. They argue in favour of consumption taxes instead of savings subsidies.²⁰ The distributive results of the structuralist proposal seem more adequate to the current situation.

On the other hand, in the government budget, expenditure cuts have been made or planned in social programmes (pensions, family allowances, make-work programmes, etc.) in order to increase public investment and transfer public savings to the private sector. Transfers of government savings to the private sector have reached an important magnitude because of a pensions reform which created a privately-funded system. The annual transfer of resources is near 3 per cent of GDP.

Finally, there is the issue of the accumulated losses of the financial sector and debtors which have been transferred to the Treasury and the Central Bank. The equity implications of their future distribution are of great importance given their very large magnitude. Fiscal and monetary policies will determine who pays the costs of the financial excesses of the past.

Another issue of investment policy concerns its public-private mix. This has ideological overtones which have been very much present in recent Chilean history and also in the approach of foreign lenders. In a way the greater reliance on public investment of the World Bank loan than in IMF policies is an implicit recognition of the need of a less ideological approach.

Structural deficits also pose the question of optimal conditionality. IMF conditionality is geared towards solving or alleviating excess demand or fundamental deficits. It frequently overlooks public savings and public investment, focusing only on the overall public deficit. The cut in the government deficit is imposed even when the deficit originates in the private sector as in Chile. We have already pointed out that, while the economy was overspending

in 1979-81, the public sector budget showed a surplus. At that time the external debt of the private sector more than tripled, while the public sector debt fell. Nonetheless in 1982 the IMF programme required a drastic reduction in the cyclical government deficit which had appeared.

An efficient high-conditionality for 'structural adjustment' should focus on expanding investment in tradables more than on reducing aggregate expenditure. The main objection has been that savings are not a policy variable and that statistics on overall savings are unlikely to be available promptly (Williamson, 1983). But since in Chile, as well as in several other Latin American countries, more than half of total investment is direct public investment and the rest is to a great extent determined by government credit, it is fair to say that total investment is very much a policy variable subject to the same degree of control as most other government policies.

Finally, the specific nature of the investment process raises the obvious question of the stability of economic policies. The general proposition that a stimulus to private investment requires a certain predictability in the range of possible future scenarios, and the probability associated to each one of them, is obviously even more relevant in a country whose entrepreneurs have experienced extreme instability and threats to property rights in the last fifteen years.

Economic policies need to guarantee a relatively stable, or at least predictable, environment in relation both to property rights and development strategy. Rules of the game for private sector property rights need to be defined in a future democratic regime. This aspect has been advanced in the debates and elaborations among the opposition to the present regime.

Greater stability of economic policies is also required to improve their efficiency in terms of desired results. If

'structural adjustment' is to be achieved we not only need to reach the 'right prices' and develop other policies required for an effective reallocation of resources, such as the availability of credit. It is also necessary for economic agents to perceive that those 'relative prices' and development priorities will last for five or ten years. We need not only the 'right' signals but also 'stable' ones.²¹ The lack of stability in the past in Chile has contributed to the development of an entrepreneurial class frequently characterized as being 'short-sighted' or with a bias towards economic activities of a 'speculative' nature. Is this not the normal trait of an entrepreneurial class subject to very unstable policy rules?

Instead of insisting so much on an optimal development strategy a more systematic effort needs to be made to define the elements that would characterize a more stable package of development policies. This requires political parties and social actors to agree on a basic minimum consensus, and to strike an agreement that may assure more stability in economic policies in the future.

APPENDIX

To analyse the adjustment process we first describe the main determinants of the dollar current account surplus (deficit). It is assumed to be an increasing function of the real exchange rate ($e-p$),¹ world income (Y^*), the capital stock in the tradable goods sector (K), and policies geared towards improving the current account (); and an inverse function of growth in domestic income (Y), world interest rates or deteriorations of the terms of trade (R^*) (equation (1)).

$$(1) \quad CA = CA(e - p, Y, Y^*, R^*, K, \quad)$$

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The domestic price level is assumed to be a weighted average of wages (w), the nominal exchange rate (e),² and 'margins' (m). The latter includes profits, public sector tariffs, ad valorem taxes, productivity and the cost of financial capital (equation (2)).

$$(2) \quad P = a_w w + a_e e + a_m m$$

$$\text{where } a_w + a_e + a_m = 1.0$$

Then,

$$(2a) \quad (e - p) = -\left(\frac{a_w}{a_e}\right) (w - p) - \left(\frac{a_m}{a_e}\right) (m - p)$$

Replacing equation (2a) in (1) we obtain (1a):

$$(1a) \quad CA = CA(w - p, m - p, Y, Y^*, R^*, K, \quad)$$

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Furthermore, the determinants of the level of output will be contingent on the prevailing macroeconomic regime. When there is excess capacity, the level of output is an increasing function of the real wage ($w - p$),³ government expenditure (g) and world output (Y^*); and an inverse

function of real margins ($m - p$),⁴ direct taxes (t) and world interest rates or deteriorations in the terms of trade (R^*). With full capacity utilization, an increase in output requires either an increase in the labour/capital ratio attained through a reduction in real wages, or a rise in net investment to enhance the stock of capital (K) (equation (3)).

$$(3) \quad Y = Y(w - p, m - p, g, t, Y^*, R^*, K)$$

Finally, the unemployment rate is assumed to be a function of the level of output (Y) and the 'employment-intensity' embodied in output composition () (equation (4)).

$$(4) \quad u = u(Y, \quad)$$

This formulation is consistent with different conditions prevailing in the labour market which determine unemployment. When unemployment is of a Keynesian nature, excess capacity results from insufficient aggregate demand and a negative relationship obtains between the real wage and the unemployment rate (equations (3) and (4)) (the negatively sloped portion of YY in Figure 1).

When unemployment is of a neoclassical nature, insufficient output is the result of the 'high' cost of labour, and a positive connection is observed between unemployment rates and real wages (the segment of YY with a positive slope in Figure 1).

Finally, 'structural unemployment' results from insufficient productive capacity (stock of capital) which in its turn is a consequence of the accumulative effects of relatively low investment rates (the vertical segment of YY in Figure 1).⁵ In these circumstances, given the capital stock (K) and output composition (), further reductions in the real wage will not increase employment levels.⁶

Implicit in figure 1 is our contention that part of the unemployment in Chile, given the present 'employment-intensity' of output, is of a structural nature. That is why the YY curve turns vertical at the $u^S()$ unemployment level which lies above full employment (u^*). The reason for the presence of this structural unemployment lies in the extremely low investment rates of past years. Between 1972 and 1985 investment in fixed capital reached only 15 per cent of GDP, substantially less than the 20 per cent registered in the 1960s. Lower investment creates structural unemployment, because of the lack of productive capacity, of over 8 per cent of the labour force (Arellano, 1984). Therefore, if 4 per cent corresponds to 'full employment' (u^*), we have to add to it the 8 per cent structural unemployment created by insufficient investment.

Equations (a) and (4) give rise to curve CA in figure 1. CA represents the combinations of real wages and unemployment rates consistent with a certain (given) current account balance. A reduction in Keynesian unemployment, when the external constraint prevails, requires a devaluation in the real exchange rate, given the rest of the parameters, and an expansive aggregate demand policy. This depreciation will induce, for constant real margins ($m - p$), a reduction in real wages (equation (2)).⁷

The vertical segment of the CA curve represents a situation, characterized by structuralists, where further devaluations of the real exchange rate do not improve the current account balance. That could be the case, for example, in a country where a fixed proportion of non-competitive imports is required for domestic production and where exports face quantitative restrictions in world markets.

We estimate that this vertical segment of the CA curve will become a relevant one for economic policy in Chile in the near future as capacity becomes fully utilized. Not in the sense that it is strictly vertical, but highly

inelastic. From a practical point of view, and given the existing limits which reduce real wages, a 'highly inelastic' and a strictly vertical curve amount to the same problem.

We estimate that in mid-1981, when adjustment policies began to be applied, the Chilean economy was at a point such as A_0 . The over-valuation of the exchange rate had moved the economy to that position starting from external balance (A). The increase in absorption for reasons different from the over-valuation of the exchange rate, already mentioned, shifted the YY curve to the right.

This trend was even further worsened by the external shocks, all of which shifted the CA curve to the right.

1. All variables are measured in logarithms, except for interest rates.
2. Absence of external inflation is assumed.
3. The increase in employment associated with higher real wages is the result of the expansion of consumption dominating its depressing effect on net exports, in a context of excess capacity.
4. Except for productivity.
5. It is not necessarily that the YY will turn vertical, but at least highly inelastic.
6. We disregard the impact of the evolution of wages over the rate of growth of the labour force. Additionally, we should recognize that in the medium run lower real wages could contribute to reduce structural unemployment, if they induce higher investment rates.
7. In terms of consumer prices both real wages and real margins fall because of the devaluation. Real margins remain constant when they are deflated by producers' prices.

FOOTNOTES

1. See Meller and Solimano (1983) for a formal test of the bubble hypothesis.
2. Some dissident academic works pointed out these disequilibria at that time: Foxley (1982, Ffrench-Davis (1982), Arellano and Cortázar (1982). A collection of columns written for the press during that time is reprinted in CIEPLAN (1982).
3. Monetary policy was aimed at improving the trade balance and reducing inflation.
4. Revell (1980) has studied European evidence on this issue.
5. A more detailed analysis of the financial liberalization process in Chile can be found in Arellano (1983).
6. For a contemporary analysis of adjustment policies which favoured devaluation and commercial policies in contrast to the automatic or contractionary path which was followed, see Arellano and Cortázar (1982).
7. Equation (1) assumes equilibrium in the goods market i.e. $Q - D = CA$. We disaggregate Q and D into tradables and non-tradables. We then assume that, given unemployment and insufficient price flexibility, in the short run Q_N is determined by D_N .
8. Aninat and Méndez. Informe de Coyuntura Económica Nacional, November, 1985.
9. In these cases, foreign creditors received more favourable treatment than local depositors. The former received 100 per cent of their funds; the latter, little more than 70 per cent.
10. See detail of this in Arellano (1984).
11. Part of this was in practice a big rediscount operation.
12. Job stability for those employed can be guaranteed by labour laws and does not need a reduction in unemployment.

13. The economy may move along the negatively sloped segment of the YY curve in Figure 1 of the Appendix.
14. See Campero and Cortazar (1985).
15. This group, and more specifically truck owners, played a crucial role in the opposition to the Allende government by means of long strikes which greatly altered the distribution process.
16. At the same time the Chilean government requested SDR 295 million from a compensatory Financing Facility.
17. We use the price of imported inputs because the prices of imports of consumer goods have fallen much more, reflecting a switch in demand to lower quality and cheaper goods. This has been another form of adjustment to the change in relative domestic prices and income. About 30 per cent of imported inputs is oil, the rest is mainly manufactured inputs.
18. Alleviating the conflict of interests between 'unions' and 'pobladores'.
19. Selectivity in terms of a shift in the composition of the government demand has been emphasized by Marfán (1985).
20. Arellano (1985) compares these policies.
21. This aspect has been emphasized by Lora (1986) when comparing export promotion policies for Brazil and Colombia.

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Table 1. CHILE: BASIC ECONOMIC INDICATORS

Years	Per capita GDP	Growth of GDP	Inflation rate	Unemploy- ment rate	Real wages	Investment rate	Public sector deficit
	(69-70=100)	(%)	(%)	(%)	(69-70=100)	(% GDP)	(% GDP)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	100.0	---	36.1	5.9	100.0	20.4	2.7
1971	108.9	8.9	26.5	5.2	123.5	18.3	10.7
1972	106.4	- 1.2	254.5	4.1	100.6	14.8	13.0
1973	98.3	- 5.6	606.1	4.8	81.3	14.7	24.7
1974	97.1	1.0	369.2	9.1	68.1	17.4	10.5
1975	81.2	-12.9	343.3	17.6	65.9	15.4	2.6
1976	83.2	3.5	198.0	21.9	67.8	12.7	2.3
1977	90.4	9.9	84.2	18.9	74.8	13.3	1.8
1978	96.1	8.2	37.2	18.0	79.6	14.5	0.8
1979	101.8	8.3	38.9	17.3	86.1	15.6	- 1.7
1980	107.5	7.8	31.2	16.9	93.5	17.6	- 3.1
1981	109.8	5.7	9.5	15.1	101.9	19.5	- 1.7
1982	89.8	-14.4	20.7	26.1	102.0	15.0	2.3
1983	87.8	- 0.8	23.1	31.4	91.0	12.9	3.8
1984	91.2	6.3	23.0	24.0	91.2	13.6	4.0
1985	88.8	2.4	26.4	22.0	87.1	14.8	---

Sources:

- Col. (1), (2): Central Bank, Cuentas Nacionales 1960-1983
 Col. (3), (5): INE and Cortázar and Marshall (1980)
 Col. (4): Jadresic (1985)
 Col. (6), (7): Central Bank, Boletín Mensual.

Table 2. CHILE: EXTERNAL SECTOR INDICATORS

Years	Prime Interest Rate	Real Exchange Rate	Terms of Trade	Export FOB	Import CIF	Current account deficit	External debt
	(1)	(70=100) (2)	(70=100) (3)	(US\$M) (4)	(US\$M) (5)	(US\$M) (6)	(US\$M) (7)
1970	7.3	100.0	100.0	1,112	956	81	3,123
1971	5.7	91.9	78.1	999	1,015	189	3,196
1972	5.3	69.0	71.9	849	1,103	387	3,602
1973	8.1	83.9	83.3	1,309	1,447	294	4,048
1974	10.7	130.6	88.0	2,151	2,016	211	4,774
1975	7.8	179.0	53.1	1,590	1,708	491	5,263
1976	6.7	144.7	57.1	2,116	1,655	- 148	5,233
1977	6.8	120.3	51.3	2,185	2,417	551	5,613
1978	9.1	134.1	50.5	2,460	3,243	1,088	7,011
1979	12.7	131.0	59.5	3,835	4,708	1,189	8,663
1980	15.2	114.4	59.8	4,705	6,145	1,971	11,207
1981	18.8	97.2	50.0	3,836	7,318	4,733	15,591
1982	14.9	112.9	46.7	3,706	4,094	2,304	17,159
1983	10.8	135.4	54.9	3,827	3,160	1,073	18,037
1984	12.0	139.5	47.2	3,650	3,738	2,060	19,659
1985	9.9	175.1	--	3,647	3,246	1,307	20,842

Sources:

Col. (1), (4), (5), (6), (7): Central Bank, Boletfn Mensual

Col. (2): Central Bank and Cortázar and Marshall (1980)

Col. (3): ECLA; Central Bank, Indicadores de Comercio Exterior

Table 3. DOMESTIC DEBTS, INTEREST RATES, ASSET PRICES

	Domestic Financial System: Loans			Real Interest Rates		Stock Market
	a/			(30 to 90 days)		Prices
	billion \$	bill \$ Dec 1982	% of GDP	Deposits	Loans	Real Values
(1)	(2)	(3)	(4)	(5)	(6)	
1970			8.5			100 <u>b/</u>
1974			5.0			93
1976			8.9	0.1	51.4	163
1979	293	509	37.9	4.4	16.6	549
1980	560	740	52.2	5.0	12.2	1,012
1981	736	888	57.8	28.7	38.8	805
1982	1,056	1,056	85.2	22.4	35.1	609
1983	1,203	977	77.2	3.9	15.9	390
1984	1,654	1,092	81.2	2.4	11.4	398
1985	2,329 <u>c/</u>	1,216 <u>c/</u>	88.0	4.1	11.1	390

Source: (1) to (3) estimated from Superintendency of Banks and Financial Institutions. From 1982 to 1985, loans transferred ("sold") to the Central Bank are included. Before 1979, loans refinanced by the Central Bank, mortgages and "contingentes" are excluded.

Notes: a/ End-of-the-year balances
 b/ December, 1969
 c/ January, 1986

Table 4. CENTRAL BANK: DIFFERENCE IN BALANCES
 DECEMBER 1981 - 1985
 (billion \$ December 1985)

Credit increase to private sector (C_B)	1,472
- to commercial banks	1,339
- to other institutions	133
Credit increase to the public sector (C_g)	279
Bonds received from the Treasury (losses transferred to it) (F)	861
Increase of net foreign liabilities ($D_B^* - R^*$)	808
Increase of domestic liabilities	1,783
- Base money (C + R)	- 83
- Commitments to the public sector	258
- Documents issued by the Central Bank (B)	1,030
- Other liabilities	578

Source: Based on annual reports of the Central Bank

Table 5. CHILE: 1983-84 PERFORMANCE UNDER THE STAND-BY PROGRAM

	1 9 8 3				1 9 8 4			
	Mar 31	Jun 30	Sep 30	Dec 31	Mar 31	Jun 30	Sep 30	Dec 31
	(millions of dollars)				(millions of dollars)			
1. <u>Net International Reserves</u>								
a) Target	1,307.0	1,177.0	1,052.0	1,052.0	1,000.0	1,115.0	1,205.0	1,190.0
b) Actual	641.0	470.0	1,220.0	1,055.0	1,099.3	1,355.7	1,314.4	1,123.4
c) (= b-a) Deviation	-666.0	-706.0	168.0	3.0	99.3	240.7	109.4	-66.6
2. <u>Contracting and guaranteeing of external debt by the non-financial public sector (more than 1 and up to 10 years)</u>								
a) Target	2,050.0	2,050.0	5,500.0	5,500.0	3,850.0	3,850.0	3,850.0	3,850.0
b) Actual	399.4	399.4	1,700.0	1,700.0	1,366.2	2,390.3	2,617.5	2,958.0
c) (= b-a) Deviation	-1,650.6	-1,650.6	-3,800.0	-3,800.0	-2,483.8	-1,459.7	-1,232.5	-892.0
	(billions of chilean pesos)				(billions of chilean pesos)			
3. <u>Net domestic assets of the Central Bank</u>								
a) Target	-6.00	4.10	13.30	24.00	140.00	160.00	180.00	217.00
b) Actual	51.40	59.90	4.00	24.00	135.70	148.93	177.07	229.65
c) (= b-a) Deviation	-57.40	-54.80	9.30	0.00	-4.30	-11.07	-2.93	12.65
4. <u>Outstanding indebtedness of the non-financial public sector</u>								
a) Target	437.00	452.00	459.00	455.00	589.89	631.96	664.07	704.21
b) Actual	429.70	444.00	449.90	468.70	582.33	602.62	639.57	704.75
c) (= b-a) Deviation	7.30	8.00	9.10	-13.70	-7.56	-29.34	-24.50	0.54

**Table 6. CHILE: THE 1985 PERFORMANCE WITH THE IMF
EXTENDED FUND FACILITY AGREEMENT**

	March	June	September	December
1. <u>Net International Reserves</u>				
(millions of dollars)				
a) Target	690.00	477.00	756.00	1,111.00
b) Actual	796.60	515.90	344.50	
c) (= b-a) Deviation	106.60	38.90	-411.50	
2. <u>Contracting and guaranteeing of external debt of the non-financial public sector</u>				
(more than 1 and up to 10 years)				
(millions of dollars)				
a) Target	650.00	650.00	650.00	
b) Actual	40.70	197.70	209.70	
c) (= b-a) Deviation	-609.30	-452.30	-440.30	
3. <u>Net domestic assets of the Central Bank</u>				
(millions of chilean pesos)				
a) Target	326.50	374.00	421.70	463.6
b) Actual	315.27	367.77	403.80	
c) (= b-a) Deviation	- 11.23	- 6.23	- 17.9	
4. <u>Net indebtedness of the non-financial public sector</u>				
(billions of chilean pesos)				
a) Target	926.10	987.70	1,052.70	1,125.90
b) Actual	924.37	987.09	1,050.10	
c) (= b-a) Deviation	- 1.73	- 0.61	- 2.60	

Table 7. FOREIGN DEBT INTEREST PAYMENTS

(in millions of dollars)

	Interest Payments	Interests Financed With:			Interests as % of		Interests financed with surplus as % of investm. in fixed cap.	Transfers to foreign banks (Interests net of new loans)
		Surplus of goods & non financial services <u>b/</u>	Reserve losses	New loans <u>c/</u>	Imports Paid	(FOB) Financed with Surplus		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1982	1,921	-383	1,165	1,139	52.7	-10.5	-10.7	
1983	1,748	630	541	577	61.4	22.1	26.6	1,486
1984	1,955	-105	-17	2,077	58.2	- 3.1	- 4.2 <u>a/</u>	726
1985 <u>a/</u>	1,800	503	0	1,297	63.9	17.9	22.6	964
1986 proj.	1,830	530	---	1,300	57.6	16.7		1,116
1987 proj.	1,900	900	---	1,000				
1988 proj.	1,970	1,250	---	720				
1989 proj.	2,050	1,550	---	500				
1990 proj.	2,080	1,780	---	300				

Notes: a/ Preliminary
b/ Transfer of real resources
c/ Includes direct investment and errors and omissions

Table 8. EXTERNAL SECTOR PROJECTIONS

	1982	1983	1984	1985	1986	1987	1988
<u>December, 1982: IMF</u>							
Exports	3,706 *	4,450					
Trade balance	63 *	1,000	1,250				
Current account	-2,304 *	-1,602	-1,000				
<u>March, 1984: IMF</u>							
Exports		3,827 *	4,100	4,600	5,100	5,500	6,000
Trade balance		1,009 *	1,000	1,300	1,600	1,800	1,900
Current account		-1,073 *	-1,300	-1,200	-1,000	-1,000	-1,000
<u>October, 1985: World Bank</u>							
Exports			3,650 *	4,168	4,684	5,159	
Trade balance			293 *	913	1,100	1,199	
Current account			-2,060 *	-1,400	-1,250	-1,151	
<u>January, 1986: IMF</u>							
Exports				3,646 *	4,012	4,478	5,016
Trade balance				712 *	836	1,223	1,600
Current account				-1,329 *	-1,300	-1,000	- 720

* Actual figures.

Table 9. EXPORT PRICES AND QUANTITIES

	Export Prices	Export Quantities	Imported Inputs Prices	Export/Import Prices	Income Terms of Trade $\frac{(1) \times (2)}{(3)}$ (5)
	(1)	(2)	(3)	(4) = (1) / (3)	
1980	100.0	100.0	100.0	100.0	100.0
1981	86.6	96.6	98.8	87.6	84.7
1982	72.4	109.7	91.0	79.6	87.3
1983	71.1	115.5	83.5	85.2	98.3
1984	67.8	115.6	84.0	80.7	93.3
1985	63.5	128.1	80.0	79.4	101.7

Source: Central Bank, Comercio Exterior, March, December, 1985.

Table 10. TYPES OF ADJUSTMENT POLICIES

	Velocity of Adjustment	Shock	Gradual
Type of Policy			
Homogeneous		4	3
		(IMF)	(World Bank)
Selective		2	1

Table 11. INVESTMENT PROJECTIONS 1985-90

	Investment (Percentage)	Trade balance (goods & serv) of GDP)	Consumption	Per capita consumption	
				Central Bank estimate	SAL* estimate
1980					100.0
1980-84					95.2
1984	13.6	-1.0	87.4		85.8
1985	13.1	3.2	83.7	86.6	83.9
1986	14.7	5.2	80.2	87.4	83.8
1987	16.1	6.0	77.9	88.2	85.2
1988	18.5	4.7	76.8	89.0	86.7
1989	20.7	3.7	75.6	89.8	86.3
1990	22.5	3.5	74.0	90.6	87.5

*World Bank structural adjustment loan.

Sources:

Central Bank: projections prepared for SAL negotiations.

Published: Boletín Mensual, Banco Central, July 1985.

Figure 1

