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Chile: Economic Vulnerability of the Pinochet Regime

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An Intelligence Assessment

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ALA 87-10028
July 1987

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Chile: Economic Vulnerability of the Pinochet Regime [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] 25X1
Office of African and Latin American Analysis, with
contributions from [redacted] 25X1
[redacted] ALA. It was coordinated with the 25X1
Directorate of Operations. [redacted] 25X1

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Chile: Economic Vulnerability of the Pinochet Regime

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Key Judgments

Information available as of 13 May 1987 was used in this report.

The relative health of Chile's economy over the past several years—it grew 2.4 percent in 1984 and 5.7 percent in 1986—has been a crucial factor in preventing opposition to the Pinochet regime from reaching critical mass. The economy, however, is vulnerable to pressure on several fronts:

- We believe that Chile's need for external financial support, especially from the international institutions, to underwrite its economic program represents a particularly sensitive pressure point. Governments of countries in the Organization of Economic Cooperation and Development (OECD) are under substantial domestic pressure to deny Santiago access to international financial resources unless Pinochet takes concrete steps to liberalize the political system. Loss of such funds would almost certainly jeopardize crucial foreign direct investment, short-term credit lines, and further debt relief from commercial bankers. This would slow Chile's economic growth, increase unemployment, and generate inflationary pressures, thus creating new political headaches for Pinochet.

- Chile's economic program, in our view, is also vulnerable to OECD trade restrictions. The country needs OECD capital equipment to maintain its export expansion, and, although Santiago could turn to Brazil, China, or South Korea as alternate suppliers, this would probably involve poorer credit terms and lower quality equipment. Santiago's "engine of growth"—exports—relies on OECD countries, which buy more than two-thirds of Chile's goods. Pinochet has little economic leverage with OECD nations because Chilean exports have no strategic importance and can be obtained from numerous other sources.

- Chile is also susceptible to internal economic threats—chiefly leftist sabotage to its economic infrastructure, mass violence, and work stoppages by unions and professional groups. Far left groups in recent years have bombed Chile's powerlines, occasionally blacking out major parts of the country. If leftists chose to attack a few key points on Chile's major roads and rail lines, they could disrupt shipping of needed goods and fuel from the coast to the nation's capital and main agricultural regions. The moderate opposition could—as the scheduled political transition nears, and the government legalizes some political activity—begin encouraging professional groups and unions to engage in work stoppages to protest against the government.

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Santiago apparently anticipates an OECD threat to veto the third stage of its World Bank structural adjustment loan later this year and to impose some minor trade sanctions over the next two years. We expect Pinochet to try to contain such pressures—as he has in the past—with deft political lobbying. We believe the government calculates it can forestall adverse actions by maintaining solid free market policies and by:

- Claiming that Chile is moving at a deliberate pace toward civilian rule.
- Publicizing its model debtor status.
- Hinting that Chile would have no recourse but debt repudiation if it were cut off from foreign funds.

Even if Chile is hit by minor trade sanctions such as EC restrictions on fruit imports or consumer boycotts, such measures, in our view, would not derail the 3- to 5-percent annual economic growth that Santiago now forecasts. Moreover, such measures probably would not cause Pinochet to speed up moves toward democracy.

In the case of tough OECD sanctions, however, such as blocking Santiago's access to development bank lending and imposing a virtual trade embargo, we believe Pinochet's room for maneuver would narrow. He would try to avoid an economic downturn that could threaten his tenure, probably by stimulating domestic industry. In our view, Chile under these conditions could boost growth for nearly a year, but, unprepared to go it alone like South Africa, would then experience increasing dislocations and slumping growth. We believe that many of Pinochet's crucial upper-class and rural supporters would become disillusioned as they began suffering economic reverses; declines in middle- and lower-class income would encourage protests and work stoppages. We gauge that at this point the armed forces would perceive Pinochet as having lost control—with economic chaos akin to that of the Allende period—and that they would probably move to replace him with an army general or a civilian leader who would set a more definitive timetable for a transition to democracy.

We believe Chile's security services, which have weakened the main Communist-affiliated terrorist group over the last nine months, will be able to contain most internal economic subversion in the next several years. The far left is concentrating on expanding its influence with organized labor and within Santiago's slums, although [redacted] it lacks sufficient support to harness anger within the unions and among the poor. 25X1

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There is an outside chance, however, that deteriorating economic conditions of the sort that would result from tough OECD sanctions could give the far left an opening to launch a campaign of violence and terrorism. In this case, Pinochet would almost certainly regain strong middle-class, upper-class, and military support and could probably contain the immediate threat. A crackdown would entail massive human rights violations, no transition to democracy, and sharpened political conflict—fertile ground for the far left's long-term plans to develop a full-scale insurgency.

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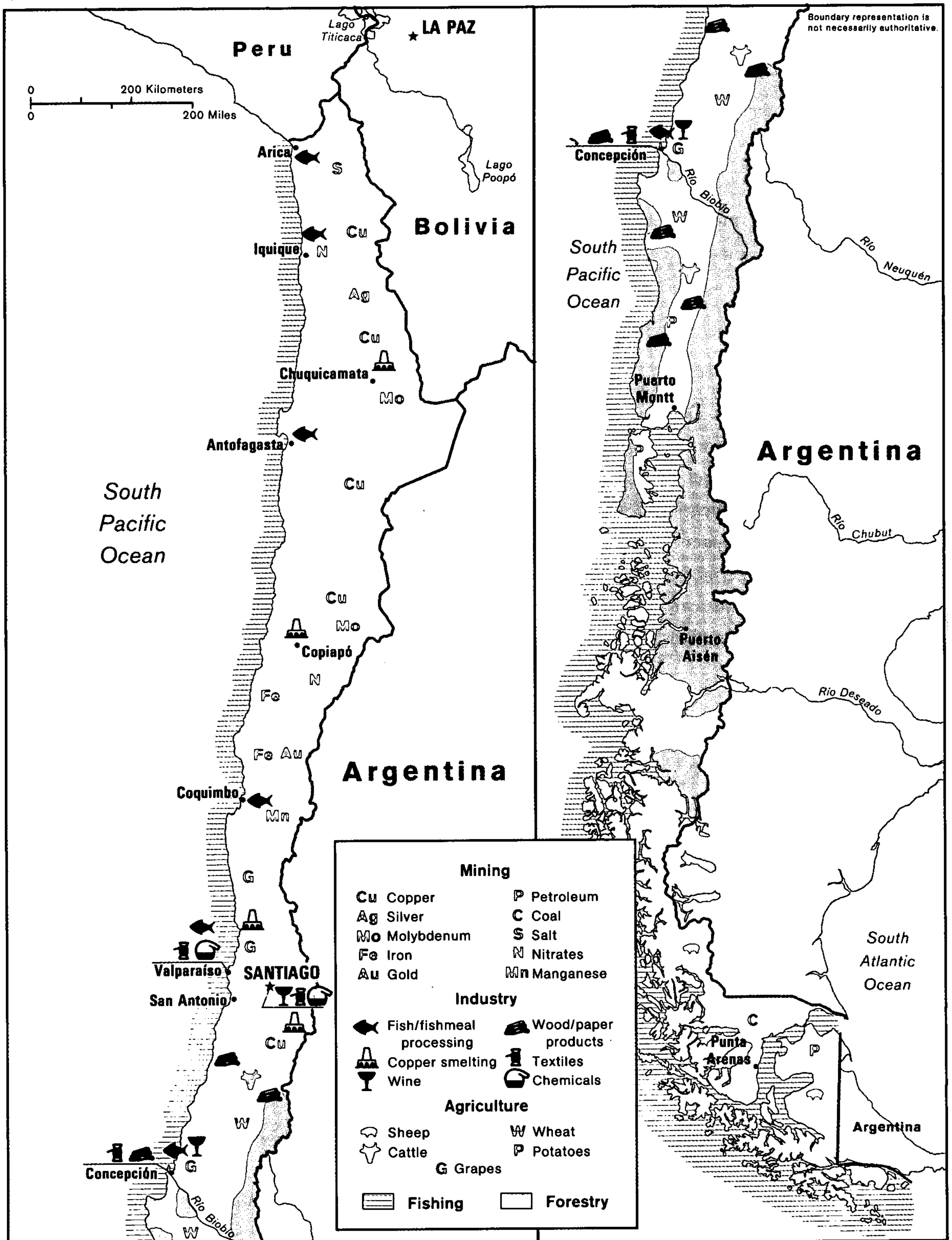

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Chile: Economic Vulnerability of the Pinochet Regime

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Introduction

The relative health of Chile's economy over the past several years—it grew 2.4 percent in 1985 and 5.7 percent in 1986—has been a crucial factor, in our view, in preventing opposition to the Pinochet regime from reaching critical mass. In addition to the general effect it has had in lessening economically motivated political discontent throughout the country, the regime's success in engineering a recovery from the economic crisis of 1982-83 has:

- Deprived the highly fractionalized moderate opposition of a unifying issue to rally the public against Pinochet.
- Increased the radical left's difficulty in recruiting lower- and middle-class cadres.
- Reassured the military that Pinochet is still the best man to ensure Chile's economic and political stability.
- Restored support for Pinochet among rightist political parties and from key business and rural interests.

Although Chile's carefully crafted economic program, having survived the recent shocks of record low commodity prices, can weather future volatility in world markets, the economy remains vulnerable on several fronts. Continuing export expansion—Chile's "engine of economic growth"—requires open world trade and a smooth flow of investment funds from abroad to build new factories at home. Internally, the country's economic infrastructure—roads, rail lines, and powerlines—lie exposed along narrow mountain terrain to terrorist sabotage, and massive work disruptions organized by key interest groups could put a stranglehold on Chile's economy. This assessment evaluates the vulnerability of Chile's economy to internal as well as external pressures and assesses the likely effect the application of such pressures would have on the country's political evolution.

Vulnerabilities to External Dislocations

Chile's economic performance is linked to an ambitious export program, the benefits of which have extended to the economy as a whole. Robust export growth in 1986 stimulated activity in other economic sectors, generating a 5.7-percent increase in GDP and helping inflation and unemployment to drop dramatically. 25X1

The export program depends heavily on the cooperation of its creditors and trade partners. The International Monetary Fund (IMF)—under an extended fund facility—has helped Chile implement fiscal and monetary policies to support the export sector. Similarly, the World and Inter-American Development Banks provide Santiago with loans and technical assistance to expand, diversify, and improve marketing. The success of the program to date has helped Santiago persuade commercial bankers to reschedule its debt at lower interest rates and to keep open $1.7 billion in short-term trade credits. 25X1

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Although the export program has generated considerable momentum of its own—Chile, for example, has boosted its savings rate, historically one of the lowest in South America, and now generates more total investment from domestic sources than from abroad—we believe it would be badly hurt if it became the target of trade boycotts and restrictions or of disinvestment by foreign creditors. 25X1

Export Vulnerabilities

Exports—equal to one-fourth of GDP—are Chile's engine of growth. The press reports that an 11-percent increase in export revenues drove economic growth to 5.7 percent in 1986.[1] US Embassy reporting indicates 25X1

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Chile's Economy in a Nutshell

Chile is generally ranked as a midrange developing country, having a relatively advanced transport, power, and communications network and some manufacturing capability. Chile's population is highly urbanized and well-educated, and substantial social spending has made it probably the most literate—over 90 percent—and longest lived in the region. Chile's economy is integrated into the world market, and is highly dependent on trade and foreign investment. In recent years, its rising export trade—which is now equivalent in value to one-fourth of the country's GDP—has spurred industrial and agricultural growth. Currently, this nation of 12 million people produces $17 billion in goods and services, on a per capita basis roughly half that of its neighbor Argentina.

Resources

Chile's peculiar geography offers a wide variety of resources that the government has been trying to tap more effectively over the last decade. The Andes Mountains that run along Chile's 4,200-kilometer eastern border contain rich metal and mineral deposits—copper, gold, silver, iron, molybdenum, nitrates, and lithium. Chile's aggressive mining policies have made it the world's largest copper exporter. The mountain slopes are home to a thriving forestry industry that produces cellulose, sawed lumber, furniture, and other wood products for export. Orchards and vineyards that spread through Chile's numerous mountain valleys yield fruits—such as apples, grapes, plums, and strawberries—that account for over 10 percent of total exports. Chile's long Pacific Ocean coastline on its western border offers a wide variety of fishing, making Chile the world's largest fishmeal exporter. By better utilizing its resources, Chile has developed a more diversified export base in recent years. Copper—which previously accounted for over 80 percent of Chile's export earnings—now represents about 40 percent. The government is also encouraging the development of natural resources for domestic use, initiating, for example, major energy projects to develop its coal and hydroelectric potential. 25X1

Dependency

Nevertheless, we judge that the country's continued development depends on access to foreign funds. Chile traditionally has had a low rate of savings, relying on export earnings and foreign sources to pay for its growth and social programs. Chile's ambitious development program in the 1970s relied on international bank lending. During the 1982 world recession and subsequent debt crash, bankers cut off Chile, leaving the country with a large debt overhang. In 1985 Santiago asked the multilateral institutions to help it develop a program to grow and pay its debts. The main features of the agreed program include: 25X1

- *An IMF Extended Fund Facility providing $750 million over three years for balance-of-payments support.*
- *A World Bank structural adjustment lending program that provides for three consecutive loan years of $250 million each with disbursement each year contingent on successful completion of the previous year's program and formal approval by the executive board for the next year's loan. Upon successful completion of the original three-year program, the World Bank may extend it.*
- *A World Bank loan of $300 million cofinanced with commercial banks for 1985-86.*
- *A collection of project loans from the World Bank and the Inter-American Development Bank worth several hundred millions of dollars to cover Chile's remaining financial gap.*

- *A commercial bank rescheduling of more than $6 billion in 1985-87 loan maturities and $700 million in loans disbursed in 1985 and 1986.*

Bankers—who have been impressed by Chile's performance under its development program, according to press reports—have granted additional debt relief in early 1987 by rescheduling most of Chile's $15 billion commercial debt and lowering interest charges. For its part, Santiago has promised to increase its domestic savings and encourage foreign corporations to invest in Chile. The export program has shown good results, but creditor countries—trying to pressure Santiago to stop human rights abuses and liberalize the political system—have twice nearly scuttled it by delaying consideration of project loans and threatening to veto the crucial World Bank structural adjustment loan.

Private Sector

Although the government controls Chile's major industries, the US Embassy reports that Santiago welcomes foreign investors and is encouraging the formation of private enterprises. Chile is courting these investors by offering the most liberal profit repatriation schemes and open-door investment policies in Latin America. The government has also offered to form joint ventures and work closely with foreign firms wanting to start new operations. Its debt-to-equity program, in our view, is helping develop a private capital market in Santiago, and the government is taking advantage of this situation by rapidly privatizing state corporations. According to press reporting, foreign investor interest in Chile is growing, but low world commodity prices, political uncertainty, and the government's unsavory international image still inhibit many investors and are preventing Chile from realizing its full economic potential.

Figure 2
Chile: Key Economic Indicators, 1984-87

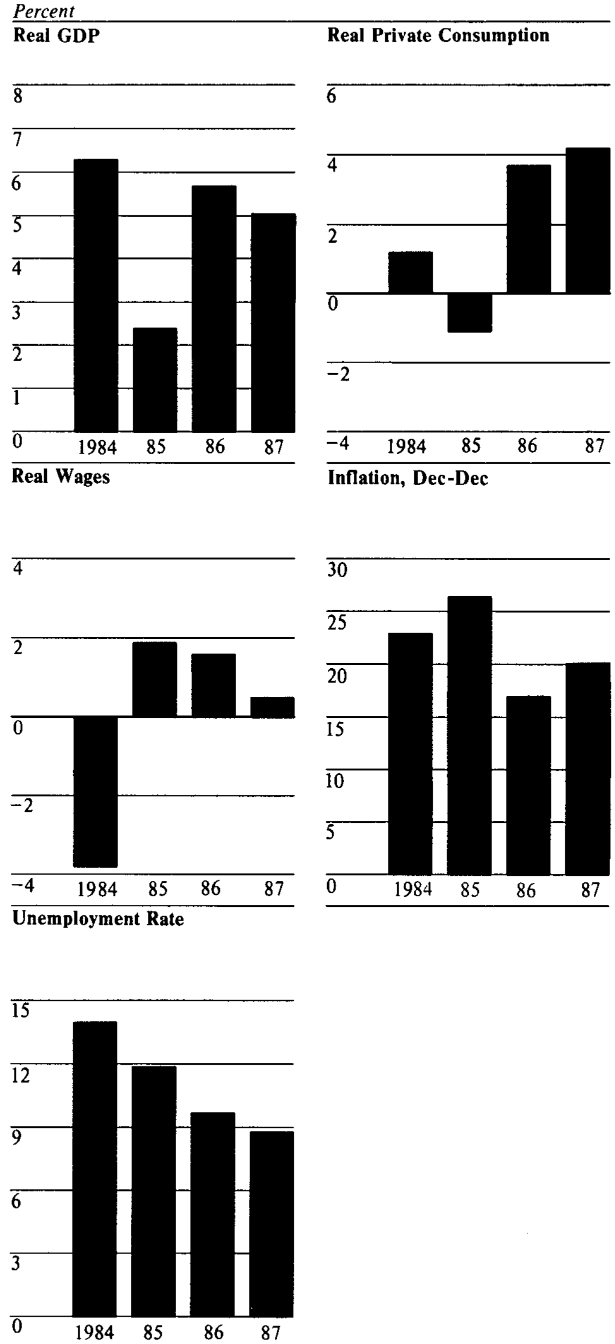

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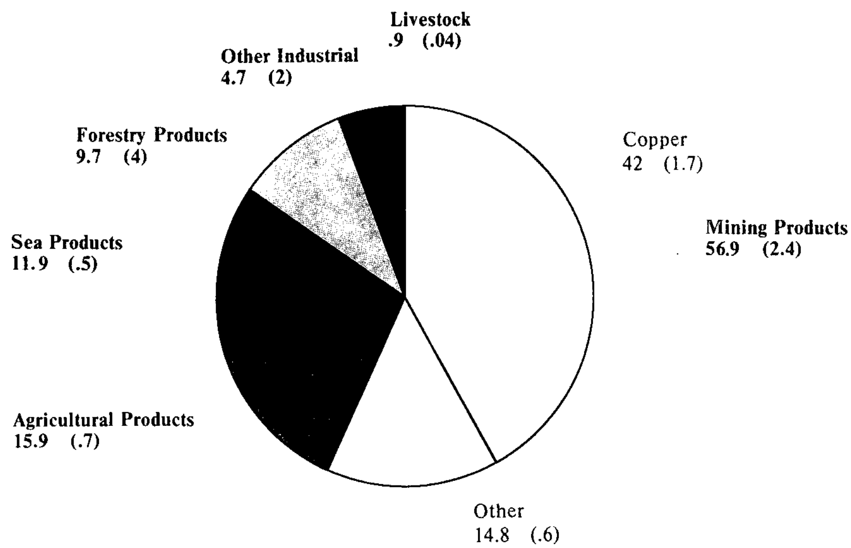
Figure 3
Chile: Exports by Product Type, 1986

Percent (Billion US $)



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that rural areas—which produce the majority of exports—have most benefited from this expansion, but the spillover effect has boosted urban commerce, construction, and manufacturing and contributed to a drop in unemployment. [redacted] 25X1

We believe, however, that Chile's export performance could be marred over the next two years by trade restrictions imposed by its trade partners—some politically inspired and others protectionist reactions to Chile's threat as a low-cost producer. For example, trade journals report that US copper producers are seeking protection against Chilean competition and that the US Congress—viewing Pinochet's repressive policies and his plans to retain power indefinitely—is considering several bills to revoke Chile's trade benefits and bar its copper exports to the United States. For its part, the EC is considering limiting apple imports from Chile, and consumer groups in Western Europe and the United States have threatened to boycott Chilean fruit to protest Santiago's human rights violations. [redacted] 25X1

Chile is understandably concerned about rumblings in OECD countries:

- The OECD buys more than 70 percent of Chile's $1.8 billion in copper exports.
- The United States and the EC purchase most of Chile's $500 million in fruit exports.
- Europe consumes the bulk of $500 million in fish products that make Chile one of the world's largest fish-exporting nations.

Pinochet, in our view, would have little leverage with OECD nations should they balk at buying from Santiago, since Chilean exports have no strategic importance and can be obtained from numerous alternate suppliers. [redacted] 25X1

Santiago is employing a variety of tactics to offset foreign pressure for political liberalization. [redacted] 25X1 [redacted] in 1985 Santiago 25X1 decided to lobby the US Congress and mount a media

Table 1
Chile: Exports, by Destination, 1986

Million US $

	Amount
Total	**4,222.3**
United States	915.2
Japan	420.1
West Germany	441.2
Brazil	292.9
United Kingdom	219.8
Italy	215.8
Argentina	160.6
Netherlands	153.6
France	153.1
Spain	122.2
China	100.2
South Korea	91.8
Belgium	77.9
Canada	58.4
Sweden	53.5
Other	746.0

[redacted]

campaign to improve its image, publicizing the steps Pinochet has taken toward a democratic transition and extolling the successes of Chile's free market policies. Likewise, press reports suggest that Chile stressed these same themes to other governments and in international forums. Nevertheless, in the event that Santiago cannot ward off sanctions by OECD nations, it is developing alternative export markets in the Pacific Rim and Arab countries. We believe, however, that major inroads in these areas could take years; to date, these new trade partners have absorbed only a small part of Chile's increase in export production. [redacted]

Even if Chile's commercial partners impose some trade restrictions, export-led growth may still, in our view, be Pinochet's safest economic strategy. Recent academic [redacted] studies conclude that trade restrictions have historically been ineffective because they have been applied unevenly as each of the participants maneuvers to protect its vested interests.[2] For example, in Chile's case West Germany might stop fruit purchases while continuing to import copper for a plant that is jointly owned and operated with the Chilean state copper company. New Zealand might restrict copper, fruit, and fish imports but continue to develop its Chilean lumber investments. Also, Chile could probably find alternative buyers for its surplus goods, although at less lucrative prices. [redacted] 25X1

Pinochet's chief alternative to export-led growth, in our view, is semiautarchy. Chile could try to reduce its dependence on the international community by improving domestic industrial capabilities and not borrowing from multilateral financial institutions. This alternative, however, is, in our view, neither politically nor economically realistic, except in the very short run. Although Pinochet might marshal public support by playing to nationalist sentiment, we believe the reality of economic hard times would soon backfire on the government. Increasing self-sufficiency would require Santiago to shift resources from export production to domestic manufacturing. Many export industries—deprived of substantial sums from the multilateral development banks—would languish. 25X1 Slower export growth would then reduce Chile's foreign exchange earnings, creating problems with creditors and obstructing imports. Chile's economy, in our view, would experience serious production bottlenecks, rising production costs, shortages, and jumps in inflation. We believe that the impact on Pinochet's political standing would be uniformly negative. As in 1983, the middle class could conclude he was losing control of the economy and the nation, sparking 25X1 recriminations from the President's erstwhile supporters in business and agriculture, strikes from vested interest groups, and criticism from the military that 25X1 could eventually threaten his tenure in office. [redacted]

[redacted]

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Import Vulnerabilities

Both the Chilean Government and private industry are aware of the importance of imports to economic growth. According to the US Embassy, Santiago has tried to reduce this dependency by encouraging business and consumers to "buy Chilean." For example, the state development corporation gives state-owned industries import substitution guidelines. The press reports that, in this manner, Chile has already reduced imports of tools and relatively unsophisticated machinery and equipment. Furthermore, the government has cut food imports to the bone by granting farmers large subsidies that shut out foreign grain. According to US officials, import substitution has reduced the nation's overall import bill by nearly 10 percent since 1984. Nevertheless, in our view, Chile still remains vulnerable to the loss of crucial intermediate and capital goods that it cannot produce domestically.

Oil is one of the most important of these potential import vulnerabilities. Petroleum imports—those from Venezuela, Egypt, Nigeria, Ecuador, and China totaled nearly $400 million in 1986—provide over half of Chile's oil and roughly 20 percent of the country's total energy needs. Petroleum plays a key role in several strategic economic areas: virtually all of the transport sector is oil based, as is over one-fourth of mining and industry. An oil shortage would cripple Chile's trucking industry—the country's main mode of transporting goods—and almost certainly create bottlenecks in mining and industrial production. The government, however, is taking measures to reduce the country's vulnerability by spreading import purchases among a variety of suppliers, by buying more foreign oil when prices are low to conserve domestic reserves, and by promoting oil exploration.

Other possible weaknesses, in our view, are the capital goods and machinery sectors. Official statistics show that as recently as 1982 Chile imported nearly 90 percent of its machinery and transport equipment. Chile relies on the United States, Brazil, the EC, and Japan for sophisticated machinery and capital imports—equal to nearly $700 million in 1986—that are vital to industrial expansion and to port, highway, energy, mining, methane, and food processing projects. US Embassy reporting suggests that, although some industrialists have stockpiled imported intermediate and capital goods, Chile's high utilization of its present capital stock has left it with little reserve capacity in this area:

- Mining equipment is needed to tap Chile's rich veins of molybdenum, iron, and precious metals, and to increase copper productivity.
- Forestry machinery is vital to expanding pulp exports and developing a pine board industry.
- Food processing and refrigeration equipment is key to growth in the fishing and fruit export industries.

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Nevertheless, we believe that Santiago has several—albeit largely unsatisfactory—options if it faces import restrictions from OECD countries. The press reports that Chile has recently improved its commercial relations with several newly industrializing countries that could take up the slack, such as Brazil, China, and South Korea. These countries, however, would probably offer poorer credit terms and lower quality equipment. The government could also try to evade trade restrictions by buying embargoed equipment from third parties, although such transactions would probably boost the price and delay delivery of crucial imports. Santiago could also respond by further developing its capital goods industry, but we judge this to be only a very long-term solution. We believe that over the two-year time horizon of this assessment a serious disruption in Chile's capital goods supply would produce production bottlenecks, ignite inflation, and damage the export program. The overall result—in the absence of a major shift in government economic policy—would probably be slower economic growth in the first year and even lower growth thereafter.

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Financial Vulnerabilities

We believe that Chile's greatest vulnerability is loss of foreign funds to meet domestic investment needs. Serious problems in this area would probably have a quicker and more severe impact on the economy than trade sanctions. Over the last decade, Santiago has tapped foreign investors, commercial bankers, and

Figure 4
Chile: Imports by Product Type, 1986

Percent (Billion US $)

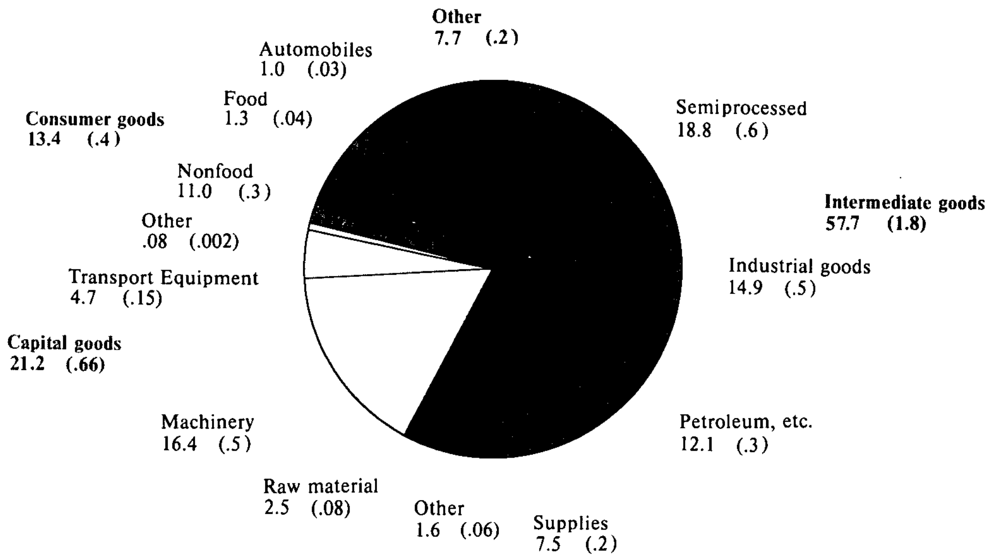

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Table 2 *Million US $*
Chile: Imports, by Country of Origin, 1986

	Amount
Total	**3,156.7**
United States	641.5
Venezuela	148.2
Brazil	247.6
West Germany	250.1
Japan	296.4
Argentina	122.5
Spain	82.2
United Kingdom	88.5
France	94.1
Egypt	34.1
Canada	54.3
Nigeria	49.5
Italy	64.0
Ecuador	58.8
Peru	56.3
Other	868.6

multilateral lenders to fund growth. Currently, multilateral institutions are Santiago's biggest investment lenders, but, in our view, loss of access to any of these sources would hurt, since all are interrelated.

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The Threat of Disinvestment. We believe that foreign companies could inflict some damage on Chile's economy by either totally diverting or repatriating profits from ongoing projects. To date, however, the press reports that most foreign firms—although leery of new commitments, given Chile's uncertain political future— are trying to improve their present operations by reinvesting earnings. Moreover, recent US Embassy reports indicate that foreign companies have expanded their ownership of current operations by using Chile's debt-to-equity conversion program. New Zealand firms—buying forestry and dairy interests—are especially active in this area. 25X1

We believe, however, that this situation could quickly change if foreign investors concluded Chile was on a collision course with commercial banks and multilateral instititutions. Under such circumstances, foreign

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Figure 5
Chile: External Debt Stock, 1986-87

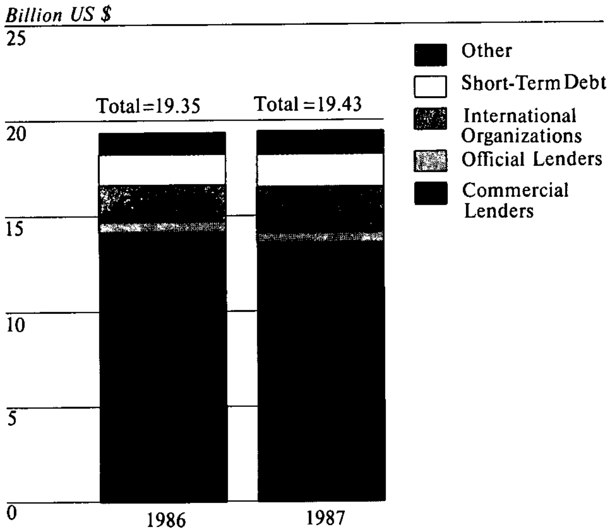

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Table 3
Projected External Debt Service, 1986-89

	1986	1987	1988	1989
Total interest service	**1,576**	**1,635**	**1,185**	**1,635**
International lenders	200	250	250	250
Commercial lenders	1,141	1,150	700	1,150
Official lenders	45	45	45	45
Short term	190	190	190	190
Total amortization	**400**	**370**	**440**	**530**
International lenders	50	100	140	220
Other	350	270	300	310

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companies would probably take advantage of Chile's liberal profit repatriation regulations and quickly move large amounts of capital out of the country to protect themselves against possible foreign exchange controls. This would slow Chile's export program as foreign owners stopped maintaining the production capacity of their factories. [redacted]

Commercial Banks. Bankers, in our view, play a pivotal role in Chile's economic stability—far greater than foreign direct investment. Bankers have responded to Chile's pleas for debt relief over the past five years by rescheduling the country's commercial debt and lowering interest rates to keep debt service manageable. In addition, trade credit lines provided by bankers "grease the wheels" of Chile's export program. According to press reporting, bankers consider Chile a model debtor, but they are willing to grant debt relief only as long as Santiago maintains its current economic policies. For example, when in 1985 and 1986 Chile's export program was imperiled by creditor country threats to veto World Bank loans, commercial banks stalled negotiations with Santiago until the loans were approved. Over the next two years, however, we judge Santiago will not require banker assistance since—according to US Embassy reporting—Chile's latest commercial agreement rescheduled all maturing debt through 1990, granted Chile low interest rates, and renewed $1.7 billion in short-term trade credits. [redacted] 25X1 25X1

The Multilateral Financial Institutions. Multilateral lending, in our view, is the linchpin of Chile's export program. The centerpiece of Chile's multilateral package is a $750 million three-year structural adjustment loan (SAL) program with the World Bank that began in 1985 with the goal of helping Santiago make the long-term economic adjustments needed to generate growth and assure timely debt repayments. Chile receives additional project lending from the World Bank and the Inter-American Development Bank, bringing total lending from the development banks to over $500 million a year. [redacted] 25X1
[redacted] Pinochet turned to these sources of funds with considerable reluctance, largely because he feared the political and economic pressures creditor 25X1 25X1

countries could apply by threatening to veto development bank loans. Indeed, should Santiago lose these funds, we judge that the country's overall access to external credit would crumble: commercial bankers probably would reduce trade credit lines and refuse debt relief, and investors probably would repatriate profits in anticipation of foreign exchange restrictions. [redacted]

Impact of Recent Financial Pressures. Notwithstanding Chile's vulnerability to loss of development bank funds, threats made over the last two years by OECD countries to veto these loans have not induced Pinochet to make any fundamental political reforms. We believe Pinochet has withstood this pressure through deft lobbying, minor political concessions, and skillful handling of commercial bankers. For example, in 1985 OECD countries threatened to veto Chile's first structural adjustment loan unless Pinochet canceled the state of siege. [redacted] the President dispatched lobbyists to Washington to argue that sanctions would jeopardize both Chile's fight against Communism and its ability to pay its debt. Meanwhile, Chile maintained good relations with bankers by servicing debts, even though the country's foreign reserves were nearly exhausted. Finally, Pinochet lifted the state of siege—although only after imposing new laws that gave him roughly the same powers—thereby securing the loan's passage. [redacted]

Nevertheless, the economy remains vulnerable to the loss of $500 million of development bank lending should Chile's critics renew their threats to cut off Santiago from multilateral funds. We believe, however, that under such conditions Santiago—anticipating that it again could defuse the danger—would repeat its past moves and hold out to the last minute before making slight concessions. Chile—with reserves sufficient to cover over eight months of imports, according to the US Embassy—is in a good position to pursue such brinksmanship. If, however, Pinochet felt that this strategy was failing, we believe he would strike back rather than accept fundamental political changes. He could:

- Carry through on previous hints that Chile would retaliate by defaulting on nearly $1.5 billion in interest payments and $15 billion in commercial debt.
- Apply selective legal discrimination against foreign banks by country of origin.
- Adopt protective trade legislation. [redacted] 25X1

Such a confrontation, however, would almost certainly provoke short-term economic problems, including capital flight, depressed foreign investment, and disrupted trade financing and commercial relations with 25X1
creditor countries. If the dispute dragged on, Pinochet, in our view, would have little recourse but to choose a policy of semiautarchy—which would in the long term probably lead to the already examined economic dislocations and political pressures on the regime. [redacted] 25X1

Internal Economic Dislocations

Chile is vulnerable to several types of internal economic threats. Potential domestic economic disloca- 25X1
tions stem primarily from sabotage against public facilities and utilities by leftist groups, massive strikes that could disrupt the economy, and the country's long-range potential for mass violence. Pinochet is not unaware of this potential: the collapse of the Allende government in the early 1970s was facilitated by rightwing terrorist attacks against highways and railroads that blocked the shipment of needed goods between the ocean ports and Santiago, and by work 25X1
stoppages organized by labor and professional groups 25X1
that disrupted general economic activity. [redacted]

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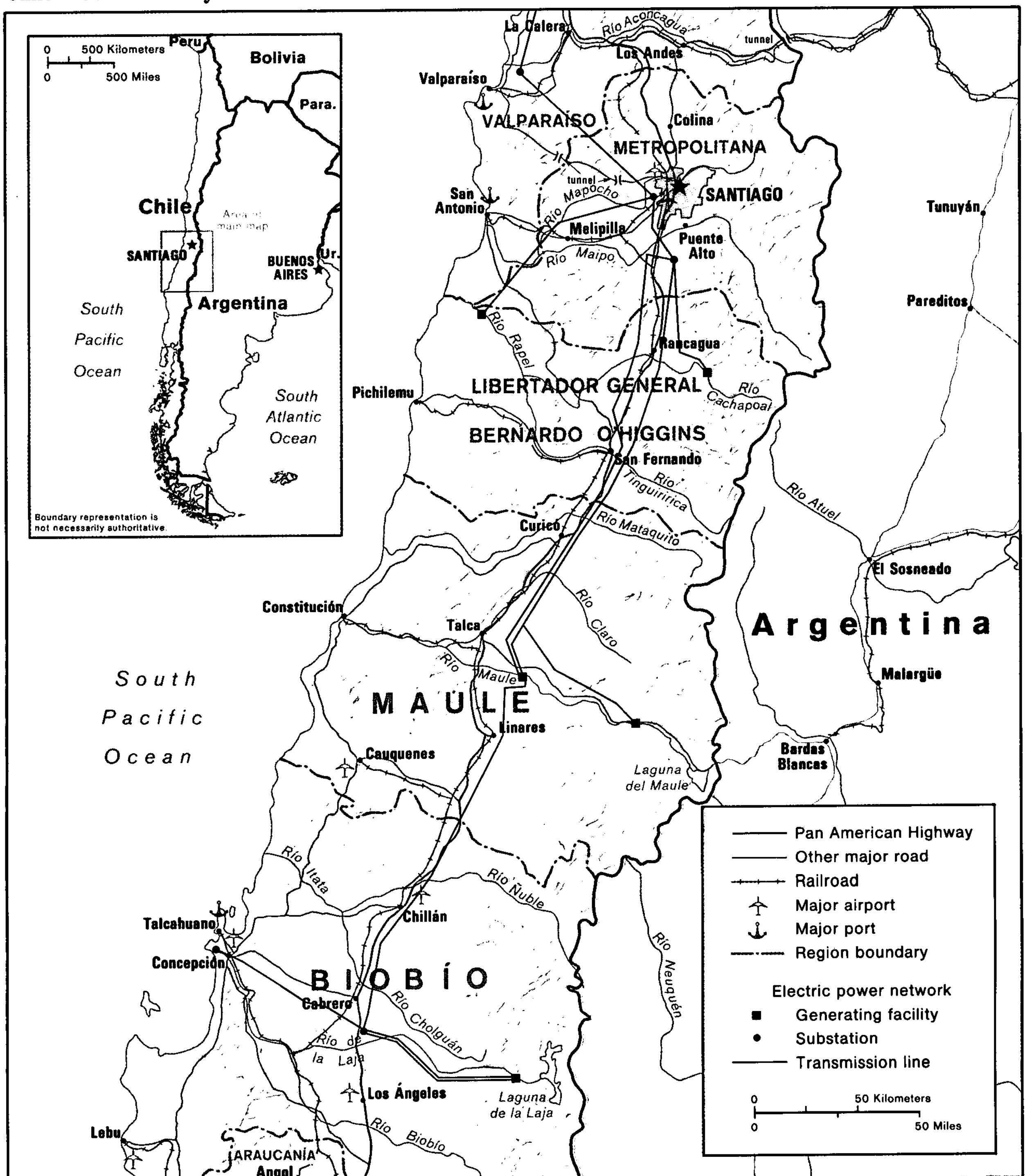
Economic Sabotage

In our view, Chile is most vulnerable to economic sabotage in Santiago and the central valley—the country's midsection that comprises less than 20 percent of the land surface but accounts for three-fourths of the population and over 60 percent of the economic wealth. The central valley runs 480 kilometers south of Santiago to the Rio Biobio and extends 50 to 65 kilometers west to the Pacific coast. A limited but well-maintained road network runs through this region of narrow mountain valleys, facilitating trucking to Santiago of foodstuffs from the central valley and imported goods from San Antonio and Valparaiso—its nearest ports. Three main rail

Figure 6
Chile: Central Valley



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lines radiate from Santiago: the north and south lines parallel the Pan-American Highway and Chile's transmission network, and the west line runs to the port of San Antonio along Highway 78. Major powerlines that crisscross the region and microwave towers and satellite dishes that dot the mountainous landscape make easy targets, and, over the past three years, leftist terrorists have exploited this by bombing the electric power grid, occasionally blacking out Santiago and at times depriving the entire central valley of electricity.[3] Mining, agricultural, and forestry exports could be readily disrupted by terrorist bombings of bridges, roads, and rail lines snaking out to coastal ports. Although government troops are stationed along these facilities, the rough terrain traversed by the transportation system makes a complete defense problematic. [redacted]

Chile has two main terrorist organizations that could conduct a campaign of economic sabotage.[4] The older, more radical, but smaller group—[redacted]—is the Castroite Movement of the Radical Left (MIR), founded in the mid-1960s. Since the police arrested many of its top leaders in late 1983, however, the MIR has fallen on hard times. It still undertakes terrorism—ranging from "armed propaganda" actions, such as distributing milk from hijacked delivery trucks to slumdwellers, to the murder of police and government officials—but, in our view, it is now little more than an irritant to the regime. [redacted]

The newer and larger Manuel Rodriguez Patriotic Front (FPMR)—which we estimate at more than 1,500 strong and which, [redacted] has ties to the Communist Party of Chile (PCCh)—has claimed responsibility for most of the more than 3,000 terrorist bombings that have rocked Chile over the past four years. These bombings—against buses, subways, business and public buildings, utility lines,

[redacted]

and military bases—have been staged in a way seemingly calculated not to cause widespread civilian injuries. [redacted] in several instances FPMR units have established temporary control over parts of Santiago's slums during anti-Pinochet protests, giving political indoctrination and weapons training to local residents. These units have engaged in gun battles with the security services, sometimes forcing them to retreat. [redacted] 25X1

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We believe, however, that the far left—facing public disapproval over the massive arms caches found by the military in September 1986 and, [redacted] hurt by the security services crackdown after the attempted assassination of Pinochet—is worried about being politically isolated and is currently on the defensive. The FPMR is temporarily reducing its violence and is working to strengthen and tighten its internal organization and expand its influence with organized labor, [redacted] 25X1

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Strikes and Demonstrations 25X1

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Chile's working and middle classes historically have been well organized and politicized. The middle class dominates most of the country's political parties and is also organized along professional lines, giving rise to organizations for businessmen, engineers, teachers, students, lawyers, doctors, and civil servants, among others. Chile's labor unions are grouped in two main illegal confederations—the Democratic Workers Central (CDT) and the National Workers Command (CNT). Both have ties to the centrist Christian Democratic Party (PDC), but the CDT avoids association with the left, while the CNT includes Communists and far leftists among its leadership. [redacted] 25X1

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We believe that, if effectively organized, Chile's professional groups and unions could wield tremendous political and economic influence. Professional 25X1

Capabilities and Intentions of Chilean Far Left Groups

In September 1980, the Communist Party of Chile (PCCh), the largest and best organized far left group in the country, announced a strategy of "armed struggle" against the Pinochet regime. Over the past four years the PCCh has carried out recruitment drives, enlarged its clandestine wing, built up its military apparatus, expanded indoctrination of the rank and file, and systematically tried to broaden the party's appeal to the masses, especially in the slum areas ringing Santiago and other cities. [redacted] *In addition, in December 1983 the PCCh supported the creation of the Manuel Rodriguez Patriotic Front (FPMR)—currently Chile's main terrorist group—which the party is now trying to bring fully under its control. We know relatively little about the structure and leadership of the FPMR, but believe it has grown from only a few dozen militants at its inception to 1,500 to 2,000 at present.* [redacted] 25X1

Several other far left groups advocate overthrowing Pinochet by force, but none approaches the FPMR in size or frequency of terrorist actions. Moreover, [redacted] *there is only minimal coordination by the PCCh and the FPMR with these groups on terrorist activities, although most of them belong to the Communist-led Popular Democratic Movement (MDP) Coalition. The PCCh uses the MDP for many of its overt political activities, such as calls for street protests and for liaison with student, labor, church, and professional groups. It also uses the MDP to keep in contact with moderate political parties and convince them that the Communists are a potent political force entitled to share in the moderates' efforts to foster a peaceful transition to civilian rule.* [redacted] 25X1

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Nevertheless, we believe that the Communists are committed to a long-term strategy of promoting an insurgency in Chile, aimed at overthrowing the Pinochet regime and establishing a Sandinista-type government under PCCh control. [redacted] 25X1

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Two unexpected events in August and September 1986 suggest to us, however, that at least some elements in the PCCh and the FPMR wanted to speed up the timetable for launching an insurrection. The first was the discovery by the Chilean security services of several caches containing about 70 tons of arms supplied by Cuba to the FPMR, [redacted] *This almost certainly was pursuant to an understanding that exists between the Castro government and the PCCh. The second was a nearly successful attempt by the FPMR to assassinate Pinochet in September 1986, which we believe must have been approved by at least some of the*

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associations and elements of organized labor contributed to Marxist President Allende's ouster in 1973 by disrupting the economy. For example, small businessmen shut down their shops for two to three days a week, doctors paralyzed health care, truckers froze shipping, and miners disrupted mineral exports with wildcat strikes. In mid-1983, many of these same groups tried to use similar tactics against Pinochet. Copper workers called several "days of national protest" to demonstrate against economic conditions and press for an accelerated political transition. A series of

PCCh leadership. We believe that this action [redacted] *indicates that Communist leaders believed that the PCCh would gain considerable political stature within Chile if it killed Pinochet and could effectively weather the expected severe reprisals by the security services.* [redacted]

The discovery of the arms caches and the failed assassination attempt, in our judgment, have put the Communists on the defensive. Press reports indicate that the public opposes terrorism and Communist-led protests. Moreover, moderate opposition parties seem intent on avoiding even the appearance of cooperating with the far left, and, in our view, improving economic conditions have dampened prospects for Communist agitators to capitalize on social discontent to foment unrest. Moreover, bombings by the FPMR have declined since at least September 1986, and the party appears to be giving little consideration to mounting major protests any time soon. Instead, Communist leaders are emphasizing the PCCh's so-called political line and are trying to cultivate the moderate opposition, while playing down the military option even to the party rank and file, [redacted] *Consequently, we believe that Communist leaders have reasserted their longer range strategy for insurgency and probably realize that their prospects will not be good for launching an insurrection before the early 1990s, and then only if Pinochet succeeds in holding on to power beyond the end of his current term.* [redacted]

strikes disrupted the country's transport network and the copper industry, leading the government to respond with a carrot-and-stick approach— combining debt relief for truckers with massive police repression—that ultimately broke the backs of the unions and quelled the demonstrations. [redacted]

Table 4
Chile: Types of Subversive Acts and Targets

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	1983	1984	1985	1986
Total subversive acts	**420**	**1,635**	**4,467**	**5,419**
Explosive charge (exploded)	190	978	829	951
Explosive charge (deactivated)	25	31	100	108
Explosive device (fake bomb)	36	24	79	41
Explosive threat (false alarm)	10	53	695	325
Incendiary device (ignited)	30	118	181	218
Incendiary device (deactivated)	1	8	14	41
Assault	38	88	102	49
Kidnaping	1	2	15	9
Other subversive acts	87	325	366	545
Acts not classified	2	8	5	33
Demonstrations, obstructions, etc.	0	0	2,081	3,099
Total targets	**420**	**1,635**	**4,467**	**5,419**
Domestic financial institutions	15	84	54	67
Foreign financial institutions	2	5	9	0
Private domestic business	39	109	170	216
Private foreign business	2	15	22	6
Government-related persons or entities	70	199	307	389
Foreign public organizations	4	5	20	5
Domestic religious organizations	0	32	12	13
Foreign religious organizations	0	2	19	28
Public and individual transportation	72	376	2,476	2,540
Public utilities	216	808	820	1,902
Not yet classified	0	0	558	253

[redacted]

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The US Embassy reports that Pinochet has taken steps in recent years to prevent a recurrence of the massive disruptions of 1983. The government has placed a variety of legal restrictions on unions that have reduced their attractiveness to workers; unions represented almost one-third of the labor force at the outset of the Pinochet regime, but now less than 10 percent. Numerous press reports attest to the effectiveness of the Pinochet regime's continuing efforts to 25X1

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destroy middle-class professional groups by depriving them of funding and support. The government—ostensibly as an austerity measure—has begun mass firing of teachers, and academic studies report that doctors have grown increasingly frustrated by government work rules and hospital conditions. The government has further hastened the decline of the professional groups' influence by dismantling housing, education, and other social subsidies that they had obtained by lobbying previous governments. [redacted] 25X1

One area where we believe social violence could increase modestly over the next several years is in Chile's extensive slums. The press reports that cutbacks in social programs have resulted in tight housing, high unemployment, and malnutrition in the shantytowns that ring Santiago. [redacted] in the capital—where the poor compose one-fourth of the four million inhabitants— leftist forces are organizing slumdwellers and urging them to mobilize against the government. The press documents that antigovernment activity—in the form of grievance meetings, noncooperation with the security services, and the erection of barricades during protests—is in fact on the rise in some slums. The sporadic nature of these incidents, however, suggests to us that the Communists do not have sufficient support among the poor to persuade them to disrupt commercial activity in the central business district or to occupy the industrial plants near their homes. [redacted] the Communist Party hopes to eventually use the slumdwellers to wreak widespread social and economic havoc, but we judge that it will make only marginal progress in this direction during the two-year time frame of this assessment. [redacted] 25X1 25X1 25X1

Outlook and Implications for the United States

In its concern about the future, the Chilean Government, in our view, worries foremost over the possibility of sanctions—especially the danger of losing access to international credits. Last fall the Pinochet regime mounted a full-scale diplomatic campaign to counteract what it viewed as threats by Washington to persuade OECD countries to stop the second stage of Chile's World Bank structural adjustment loan. The government reacted equally strongly early this year when—faced with a bank committee deadlock—it threatened a debt moratorium unless bankers quickly concluded a debt relief agreement, according to Embassy reporting. We agree that a cutoff of international credit is Chile's greatest single economic vulnerability because it would deprive the country of needed foreign funding, hurt trade, reduce foreign direct investment, and provoke capital flight. [redacted] 25X1

Santiago is also clearly worried about the damage trade sanctions could do. For example, Chile has reacted to the Kennedy-Harkin sanctions bill, which would revoke its Generalized System of Preferences (GSP) trade benefits and ban US copper imports, by attacking it at home as an intrusion into internal politics and by trying to convince the US Congress that Chile is already moving toward democracy. [redacted] 25X1

Despite being aware of its vulnerability, Santiago has not attempted to insulate itself from politically motivated economic pressure on the model of South Africa. We believe the government calculates it can forestall the formation of an OECD movement for sanctions against Chile by maintaining free market policies. We expect Santiago to continue to buttress its position by:

- Claiming that it is making fundamental political reforms and is on a deliberate pace to civilian rule.
- Publicizing its model debtor status.
- Hinting that it would have no recourse but debt repudiation if it were cut off from foreign funds.

[redacted] 25X1

Santiago probably expects only very moderate external pressures—similar to last year's maneuvers surrounding the World Bank vote—over the next two years. [redacted] the government believes creditor countries will fail to stop its third World Bank structural adjustment loan coming up for approval later this year, although it recognizes that the uncertainty preceding the vote will probably delay other development bank project loans by several months. Santiago may also expect minor 25X1 25X1

The Role of the Security Services 25X1

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We believe that over the next two years the security services will be an effective counterweight to any attempt by the far left to mount a concerted campaign of economic subversion. The Carabineros—Chile's 28,000-man national police—remain a highly professional, capable, and disciplined force, despite the strains on morale and resources caused by leftist violence over the last five years. To supplement the Carabineros and the intelligence services—currently the principal forces involved in countering radical leftist violence—the regime can use the 60,000-man Army and special units from the Navy and the Air Force. [redacted]

Although the security services have suffered from lack of intelligence on the terrorists' plans—illustrated by the assassination attempt on Pinochet and infiltration and caching of massive amounts of arms—they have responded effectively on a counterpunch basis. [redacted] *after the assassination attempt, the Carabineros and the National Information Center (the primary intelligence agency) arrested many FPMR members, causing the group to temporarily scale back terrorist operations. We judge that, in the event of a full-fledged terrorist offensive aimed at crippling Chile's economy, the regime would rely principally on the intelligence services to carry out counterterrorist operations, but would make extensive use of regular military units to protect vital industrial, communications, and transportation infrastructure.* [redacted]

In our view, the security services will continue to effectively suppress strikes and demonstrations. [redacted] *Both the Carabineros and Army and Air Force units regularly conduct security sweeps through the poorer sections of Santiago to intimidate the inhabitants, and to disrupt opposition groups' efforts to organize protests. The Carabineros are well-trained in crowd-control techniques and use effective, if occasionally brutal, measures to disperse demonstrators.* [redacted] 25X1 25X1

Even though the regime's security apparatus would be able to contain economic subversion, the costs over time could be high. A prolonged coordinated campaign of mass social mobilization and economic sabotage—though unlikely over the next two years—would tax the resources of the security forces and might begin to undermine morale. The use of Army troops—who, in our judgment, are more likely to respond with excessive force than the police—to quell massive demonstrations would probably lead to higher civilian casualties, spurring a domestic and international reaction and causing unease among senior military officers who have opposed an increased role for the armed forces in controlling public protests. At the very least, we judge that stepped-up security measures would absorb resources that could otherwise have aided economic growth. [redacted] 25X1 25X1 25X1 25X1

trade sanctions, such as Washington's removing some tariff concessions on Chilean goods or eliminating Chile from Overseas Private Investment Corporation (OPIC) eligibility and European Community restrictions on fruit imports. [redacted]

Should this scenario play out, Chile's economic growth is likely to stay within the 3- to 5-percent annual range that Santiago now forecasts, with no dramatic economic dislocations over the next two years. We do not believe this level of pressure would cause Pinochet to speed up moves toward democracy or make any meaningful political concessions. [redacted] 25X1

Impact of Tougher Measures 25X1

Any number of unanticipated political events in Chile, however, could elicit repressive measures from Pinochet, which, in turn, could help forge a strong OECD

Table 5
Chile: Balance-of-Payments Projection, 1986-89

Billion US $

	1986	1987	1988	1989
Current account balance	−1,124.3	−930	−571	−898
Trade balance	1,065.7	1,100	1,089	1,200
Exports	4,222.4	4,418	4,889	5,400
Imports (c.i.f.)	3,156.7	3,318	3,800	4,200
Nonfinancial services and transfers	−303.0	−400	−400	−448
Financial services	−1,887.0	−1,630	−1,260	−1,650
Capital account balance	1,243.3	872	539	570
Foreign direct investment	319.0	450	280	250
Regular	57.0	100	30	100
Debt conversion	262.0	350	250	150
International lending institutions	236.0	367	375	400
Sal I, II, III	275.0	225	125	0
Net amortization	−295.0	−770	−760	−680
Other long-, medium-, and short-term inflows	708.3	600	519	600
Change in reserves	119.0	−58	−32	−328

front that would impose tough sanctions such as rejecting further development bank lending to Chile and imposing an effective trade embargo—for example, if:

- The far left succeeded in a rash of high-visibility bombings and made another assassination attempt against Pinochet.
- The moderate opposition used its increased media access to organize work stoppages and protests against the government.
- A consensus developed in the Army officer corps to replace Pinochet.

The President might then try to secure his rule through a massive crackdown. If Pinochet were then faced with a concerted effort by the world community to destabilize his regime through economic sanctions, we judge that he would probably declare a moratorium on Chile's commercial debt, discriminate against OECD-based branch banks, and regulate or expropriate mining corporations operating in Chile, including US investment estimated at well over $1.25 billion. He would also almost certainly try to preserve growth by reducing domestic consumption to boost savings and redirecting investment to industry, such as reactivating Chile's underused automotive and small manufacturing industries. 25X1

Economic Consequences

The initial results, in our view, would be rapid growth led by the manufacturing sector and a drop in urban unemployment. Chile is not prepared to sustain such marked shifts in economic strategy, however, and the resulting prosperity would almost certainly evaporate within two years. Industrial bottlenecks would begin crimping growth within 12 months as supplies of intermediate and capital goods became exhausted. The agricultural sector would find a good domestic market in the first year or two, but we doubt the government could sustain its price-support program, and farmers' profits would eventually fall, as would agricultural production. Exporters would be buffeted by increasingly uncertain markets and lower prices, forcing further dislocations in production and employment. US commercial banks would probably lose their loan portfolio in Chile, and any surviving US commercial operations would be hobbled by regulations. 25X1

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Political Repercussions

Pinochet's political prestige might be buoyed initially by a rally-around-the-flag sentiment, but we believe that much of his crucial upper-class and rural support would dissipate as farmers and exporters began suffering reverses and as industrialists—experiencing production bottlenecks—recognized their uncertain future. The political parties would capitalize on shortages and inflation, and declines in middle- and lower-class income would encourage protests and work stoppages. Furthermore, we judge that the armed forces would begin to perceive Pinochet as a national liability—having plunged the country into economic chaos akin to that of the Allende period—and that eventually he would be replaced by either a senior

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army general or a civilian, either of whom would move at a more deliberate pace to restore democracy and free the economy from sanctions. [redacted]

Sanctions Amid Internal Disruptions

Tough sanctions against Chile, however, are not risk-free for the West. Economic problems could spur—or simply accompany—heightened violence, terrorism, sabotage, and the beginnings of leftist guerrilla activity. Given the capabilities of Chile's security services, we see this scenario as unlikely over the next two years. Nevertheless, the security services are already strained, and the arms caches and the attempted assassination of Pinochet demonstrated that the terrorists have the wherewithal to pull off some spectacular blows. Terrorists might also find recruitment and mass social mobilization easier during bad and uncertain economic times. [redacted] 25X1

[redacted]

We believe, therefore, that there is a chance that strong sanctions could help the left mount a serious threat to the government. Pinochet would almost certainly respond by blaming the country's woes on the Communists, marshaling middle- and upper-class support by raising the Allende specter, and by arguing to the military that he was the only alternative to political and social disintegration. We believe that such a strategy would probably contain the immediate leftist threat. Nevertheless, it would be accompanied by massive human rights violations, no transition to democracy, and sharpened political conflict—fertile ground for the far left's long-term plans to develop a full-scale insurgency and install a Communist government in Chile. [redacted] 25X1

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Statistical Appendix

Table A-1
Chile: Export and Imports, by Region, 1986

Million US $

	Amount
Exports	**4,222.3**
North America	973.6
Common Market	1,441.3
Aladi	685.2
East Asia	730.4
Middle East	89.4
Africa	32.5
Other	269.9
Imports	**3,156.7**
North America	695.8
Common Market	588.7
Aladi	732.4
East Asia	446.8
Middle East	38.0
Africa	86.8
Other	568.2

Table A-2
Chile: Gross Domestic Product, by Sector, 1986

Percent

	Share
Agriculture	8.8
Fishing	1.0
Mining	8.4
Industry	20.7
Electricity, gas, and water	2.6
Construction	5.5
Commerce	16.7
Transportation	5.7
Others	30.6

Table A-3
Chile: Public Investment Program, 1986

	Percent
Total investment as share of GDP	15.2
Government as share of GDP	7.7
General government	44.5
Housing	11.4
Irrigation	0.4
Roads	11.8
Santiago subway	0.8
Water and sewerage	2.8
Health, education, and housing projects	4.8
Other	12.5
Public enterprise	55.5
Copper company (CODELCO)	24.0
Power companies (ENDESA/CHILECTRA)	11.3
National petroleum company (ENAP)	8.6
National mining company (ENAMI)	1.0
Chemical company (SOQUIMICH)	1.0
Steel company (CAP)	1.7
National railroads	0.6
Port authorities (EMPREMAR, EMPORCHI)	1.0
Other	6.3

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Table A-4
Chile: Savings Requirements, 1986-87

Billion US $

	1986	1987
Total	**15.7**	**16.1**
Foreign savings	6.4	5.2
National savings	9.3	10.9
Public savings	4.4	4.7
Private savings	4.9	6.2

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