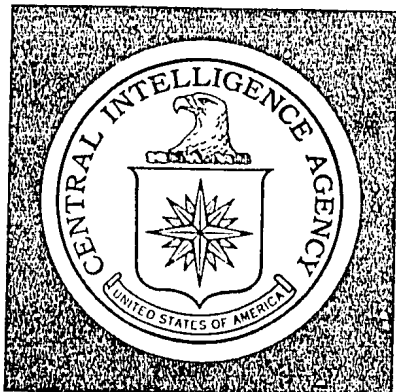


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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Chile's Copper Earnings: Outlook and Implications

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ER IM 68-44

May 1968

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
May 1968

INTELLIGENCE MEMORANDUM

Chile's Copper Earnings: Outlook and Implications

Summary

The outlook in Chile is for continued high copper revenues in 1968, a sharp decline in revenues in 1969, and a partial recovery in 1970. Total Chilean export earnings are likely to be lower in 1969 and 1970 than in 1967, in contrast to an increase of about 40 percent during 1965-67. In consequence, imports probably will have to be severely restricted. Under these conditions there will probably be a slowdown in economic growth and an acceleration of inflation. The Christian Democrats, the party in power, thus are in danger of approaching the congressional elections of March 1969 and the presidential election of September 1970 in an atmosphere of heightened popular dissatisfaction with economic conditions.

The US copper strike that began in July 1967 led to price increases that substantially increased the value of Chile's copper exports and strengthened its foreign trade position. The rise in Chilean copper prices above the pre-strike level made the value of exports about \$70 million higher and government revenues nearly \$40 million higher during the period August 1967 - February 1968 than they would have been otherwise. An expansion in export

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volume brought further benefits. However, these gains in export earnings and government revenues -- like the gains arising from the high prices of 1966 -- were partly offset by a reduction in foreign aid from the United States because Chile had less need for budgetary support.

The settlement of the copper strike in the United States and the resumption of full-scale production probably will begin to exert heavy pressure on copper prices in the last months of 1968. For the year as a whole, however, Chile is expected to receive an average price of 45 cents per pound, about the same as in 1967. During 1969 and 1970 the price is expected to drop to an average of about 35 cents. Output from new mines is likely to boost the volume of copper exports substantially in 1970, but their value probably will remain lower than in 1968.

If the value of exports develops as expected, the Chilean government will have to drastically reduce the growth of imports, which averaged 20 percent per year during 1966-67. The direct and indirect effects of a pinch on imports on the supply of goods seem likely to set the stage for rampant inflation -- particularly since the administration probably will be unwilling, and perhaps unable, to crack down on union demands for large wage increases. The impact of reduced copper earnings on tax revenues also will intensify inflationary pressures and promises to seriously restrict the government's maneuverability in economic matters in 1969-70.

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Background

1. Chile made encouraging economic progress during 1965-66, the first two years of the incumbent Christian Democratic administration, headed by Eduardo Frei. Growth rates were high, the foreign payments position was strengthened, and the chronically high rate of inflation was slowed. The economy slumped in 1967, however, and difficulties are looming for the next few years. One of the most important elements in the progress of 1965-66 and in the unpromising outlook for 1969-70 is the changing level of earnings from copper exports.

2. Copper prices in the world market are of vital interest to Chile because of the metal's great importance in the economy. Chile has been a leading exporter of copper for many years, and copper typically makes up more than 70 percent of the total value of the country's exports. Copper exports in 1967 amounted to 615,000 tons* -- about one-fourth of world exports -- and were valued at some \$615 million.** Copper production, which usually represents about 15 percent of production in the Free World, amounted to 665,000 tons in 1967. In that year the copper industry provided nearly one-sixth of the total current revenues of the Chilean government, originated 8 percent of the gross national product (GNP), and employed about 5 percent of the industrial labor force. At the 1967 level of output and exports, a 1-cent change in the price of copper would cause an annual change of \$15 million in the value of production and gross profits, \$14 million in foreign exchange earnings, and about \$9 million in government revenues.

* *Tonnages are in metric tons.*

** *Export data in this memorandum include direct exports of refined copper, blister copper, and concentrates. Fabricated copper is excluded.*

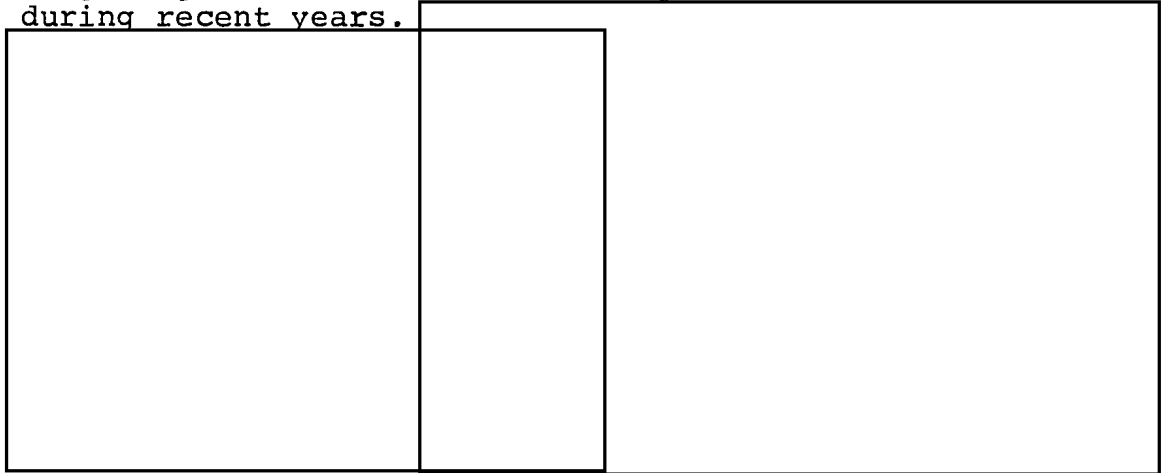
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3. The industry is dominated by three large companies -- referred to in Chile as the *Gran Minería* (Large Mines) -- which produced 85 percent of the total output in 1966. Two of the companies, owned by the Anaconda Mining Company, operate the Chuquicamata and Salvador mines. The government of Chile and the Kennecott Copper Corporation jointly own the third company, which operates the El Teniente mine.

4. The major Chilean copper companies operate efficiently under favorable natural conditions and earn high profits, although periodic strikes and large wage boosts have increased production costs during recent years.

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Recent Trends in Copper Prices

5. The average annual export price received by Chilean producers for their copper remained

* Money wages of the copper workers have risen an average of about 40 percent per year since 1963, but the impact of these gains on real production costs and profits has been partly offset by successive devaluations of the escudo that cut its value from 2.15 escudos per US dollar at the end of 1963 to 5.79 escudos per US dollar at the end of 1967.

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relatively steady during 1959-64, ranging between 29 and 32 cents per pound.* Chilean copper prices during this period were strongly influenced by the controlled US wholesale price. The Chilean price moved somewhat higher in 1965, reflecting the advance in world copper prices resulting from a rapid growth of demand and the disruption of exports from Zambia and Chile. To take advantage of the strong market in late 1965 and early 1966, the Chilean Copper Corporation -- the government agency that sets the producers' price** for copper -- raised this price in January, April, and July 1966. In August 1966 the agency abandoned the practice of fixing the producers' price administratively in favor of a system of producers' prices based on daily quotations for wire bars on the London Metal Exchange (LME). Since October 1966 the producers' price has been tied to the asking price for three-month futures contracts for wire bars on the LME.***

* These are unit values on an f.o.b. basis for Chilean exports of refined copper, blister copper, and concentrates. In 1966, refined copper and blister copper accounted for 54 percent and 40 percent, respectively, of the total value of these exports. Differences among Chile's export prices, the export prices of other major exporters, and wholesale prices in world markets reflect such factors as (1) the specific form (or relative importance of various forms) of copper being priced; (2) the cost (or differences in cost) of transportation, insurance, and handling of copper moving to market; and (3) the specific contractual arrangements made concerning the determination of export prices.

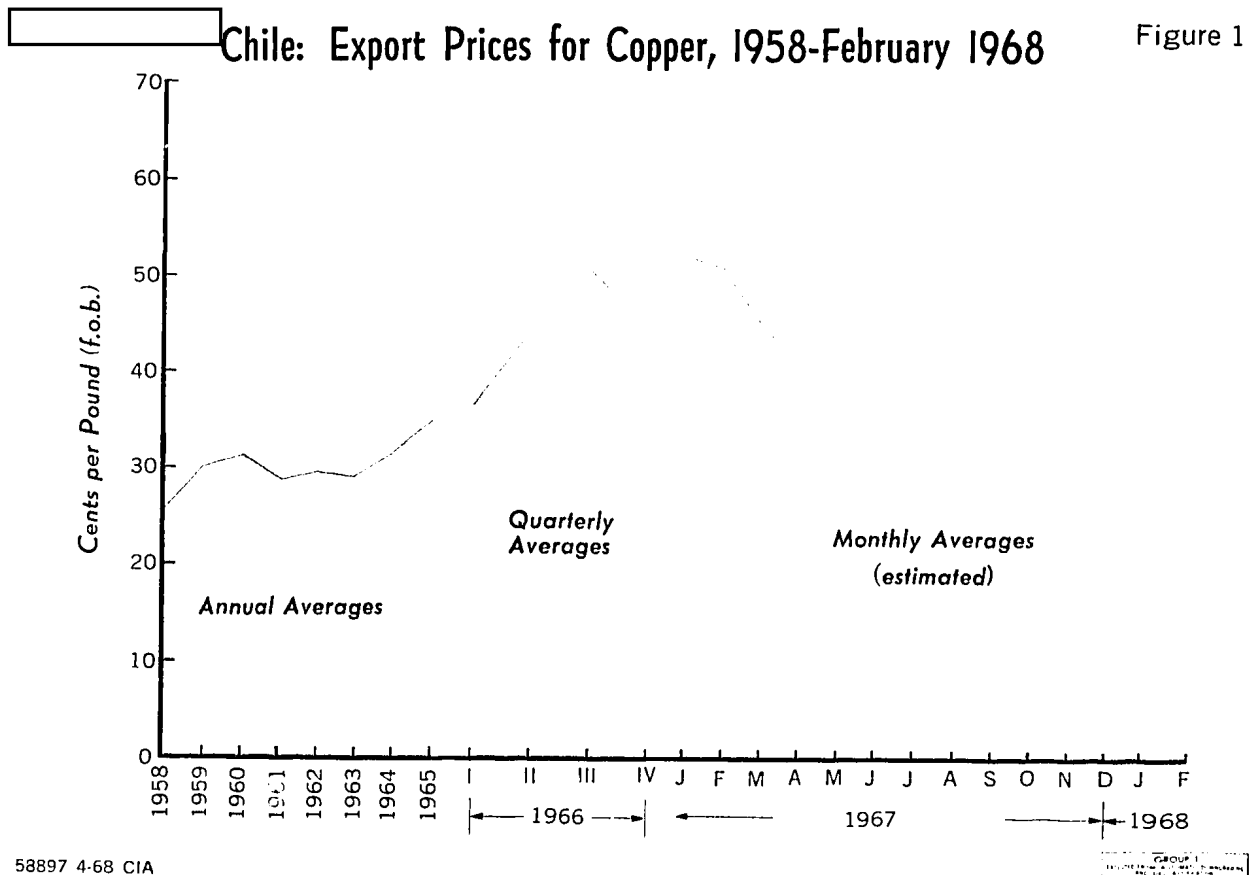
** Little or no copper is actually exported or sold domestically at the producers' price. This price is merely a base to which one of several complicated formulas may be applied in determining prices for exports and domestic sales.

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6. The strong demand for copper in 1966 and the change in the Chilean pricing system brought an increase in the average export price from 36 cents in the first quarter to 44 cents in the second quarter and 51 cents in the third (see Figure 1). A decline to 45 cents in the final



quarter resulted in an average price of 44 cents in 1966, compared with 35 cents in 1965. The price declined further through early 1967 and leveled out at about 42 cents from April through July, when the US copper strike began. The shortages of copper caused by the strike, which restricted operations by all of the major producers, induced a rise in the Chilean export price to an estimated 56 cents a pound in November 1967 and 62 cents a pound in February 1968.

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Effects on the Balance of Payments

7. These trends in copper prices combined with a steady rise in the volume of copper exports produced a large increase in the value of copper exports in 1966 and a smaller, but still considerable, increase in 1967. The rise in copper earnings in 1966 -- amounting to \$150 million -- gave a strong boost to the economy. The increase in export earnings permitted a 30-percent increase in imports over the 1965 level. Capital goods and foodstuffs and other consumer goods registered the largest increases. The imports of foodstuffs probably contributed to the downturn in the inflation rate in 1966, while the machinery and equipment imports raised productive capacity. Chile also was able to boost reserves of gold and foreign exchange by 25 percent, to \$172 million.

8. In 1967 and early 1968, Chile benefited considerably from the US copper strike, even though part of the gain was offset by a reduction in US aid. Reliable estimates of export expansion attributable to the strike are not yet available, but the effect of the higher level of prices on the value of Chilean copper exports can be estimated. Based on an estimated average Chilean export price of 42 cents during the four-month period before the strike, Chile received a windfall averaging about 9 cents per pound for exports from August 1967 through February 1968. Exports were averaging about 50,000 tons monthly during the year before the strike, and the increase in prices thus raised their value by about \$70 million.

9. The spurt in copper prices in 1967 helped to boost the value of copper exports for the year as a whole to \$615 million, or 9 percent more than in 1966 and 70 percent more than the average for 1960-65. Exports other than copper weakened somewhat in 1967, however, holding the increase in total exports to less than 3 percent (see Figure 2). Continuing rapid growth of imports -- especially of foodstuffs and capital goods -- held the trade surplus to \$25 million compared with \$85 million

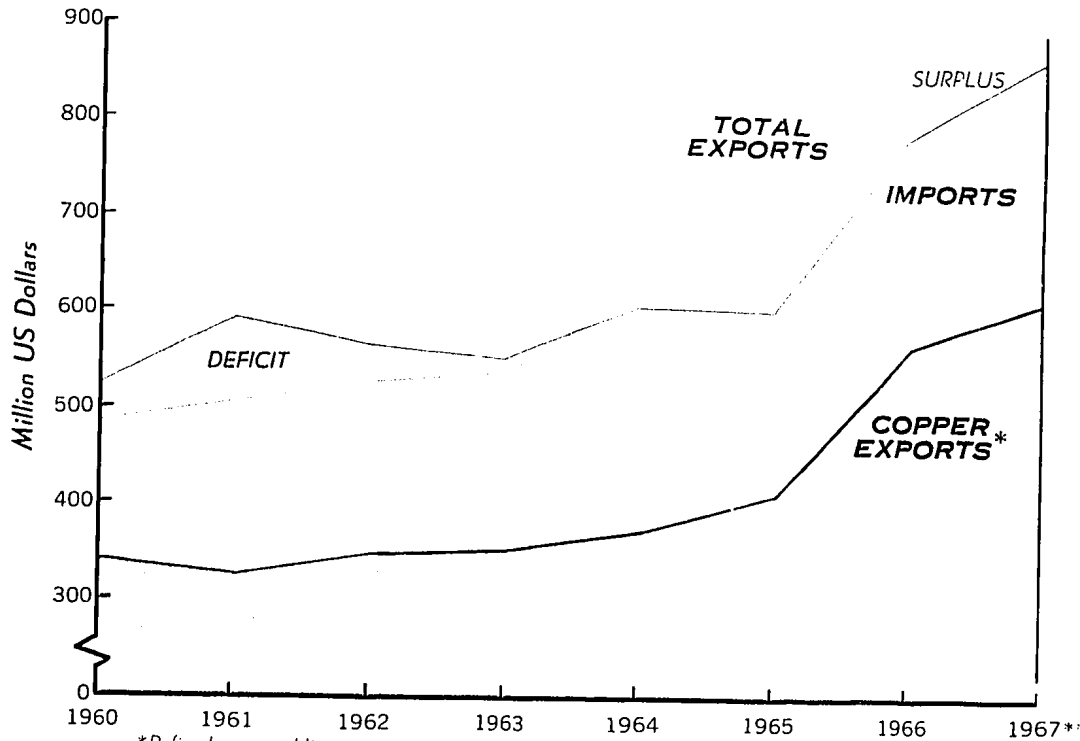
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in 1966. Moreover, holdings of foreign exchange declined during the year from \$172 million to \$126 million. This decline was mainly the result

Chile: Trends in Exports and Imports, 1960-67

Figure 2



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of large repayments of credits from the IMF and other foreign institutions. Also, payments for imports accelerated following the government's decision to release foreign exchange for this purpose 50 days rather than 70 days after shipment of the goods.

Effects on Government Revenues

10. The sizable increase in the government's copper revenues in 1966 enabled it to greatly expand public investment, which constitutes about three-fifths of total investment and is particularly important in agriculture, transport, and construction. At the same time, the Chilean government

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was able to reduce its chronic budgetary deficit to 11 percent of expenditures compared with 17 to 19 percent in the preceding three years. In December 1966, President Frei declared that Chile's budgetary improvement and need for fiscal discipline made budgetary support from the United States (which amounted to \$80 million in 1966) and standby credits from the IMF unnecessary during 1967. Frei indicated, however, that US project and sector loans would still be requested and that budgetary support would be asked at a later date if the price of copper declined drastically.

11. Frei's decision concerning US aid proved to be hasty. The weakening of Chile's export prices in the first half of 1967 and the government's decision to forego budgetary support from the United States forced the curtailment of plans for public investment in that year. The rate of growth of public investment consequently declined from an average of 25 percent in 1965-66 to only 8 percent in 1967. Investment outlays for transport and housing were actually smaller in 1967 than in 1966, and this drop contributed to the decline in construction activity. Reduced construction activity and lagging agricultural output were the main factors in the decline in the growth rate for Chile's GNP from nearly 7 percent in 1966 to about 3 percent in 1967.

12. A windfall in government revenues during August 1967 - February 1968 of about \$40 million was generated by the price rise that followed the US copper strike. This increment was not necessarily a net gain, however. The government of Chile anticipated budgetary support from the United States of about \$45 million for 1968, but it has not yet been authorized because of the high copper prices. Although US-Chilean discussions in early 1968 focused on a scaled-down request of about \$15 million to \$20 million, the outcome is as yet uncertain.

Outlook for Copper Prices and Export
Earnings in 1968-70

13. The outlook for copper prices and Chilean export earnings is favorable for the remainder of 1968 even though the US copper strike has been

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settled. It will take a number of weeks for US producers to resume the normal flow of copper to customers and a number of months to rebuild stock-piles to their normal levels. US defense requirements for copper in 1968 are running well ahead of last year's requirements. Demand probably will remain strong relative to available supplies through most of 1968, and prices are not likely to weaken seriously before the last quarter of the year. Chile's average export price in 1968 consequently is expected to approximate the 45-cent average of 1967. At this price, the expected expansion in the volume of copper exports will boost their value in 1968 to some \$650 million, or 6 percent more than in 1967 (see the table).

14. However, full recovery from the effects of the US copper strike and substantial increases in production capacity are expected to weaken seriously the world market prices for copper, beginning in late 1968. All of the major world producers have large expansion programs under way; world mine capacity is expected to increase by about 40 percent between 1966 and 1972. This scheduled expansion of output -- averaging nearly 6 percent per year -- probably will cause prices to drop, because demand normally does not grow that rapidly. The 42-cent price for refined copper that was recently announced by Phelps-Dodge and Anaconda probably cannot be maintained in 1969-70 if world output progresses as now expected. On the other hand, the substantially increased wage rates provided in the US producers' new agreements with the labor unions are likely to establish a higher level of copper prices in the future than in the early 1960's. Under these circumstances, it seems reasonable to anticipate an average Chilean export price of about 35 cents in 1969-70.

15. A decline in Chile's export price to 35 cents would substantially reduce the value of copper exports in 1969. Even if a 7-percent rise in the volume of copper exports in 1969 is assumed, the value of exports would decline by about one-sixth, or some \$110 million. In 1970, however, the

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volume of production and exports is expected to increase more rapidly. Two new joint companies, one pairing the Chilean government with Anaconda and the other with the Cerro Corporation, are scheduled to begin production at new mines under the "Chileanization" copper agreements of 1966. This program calls for a doubling of copper production over the 1966 level by 1972. The newly established companies were given significant tax reductions as an inducement for the private foreign participants to invest about \$500 million. By 1970 the value of copper exports is expected to regain the level of 1967 (some \$610 million). It would, however, remain about \$40 million below the level anticipated for 1968.

Economic and Political Implications

16. Although copper earnings may hold up well for several more months, the general outlook for the Chilean economy during the next two and one-half years is distinctly unfavorable. Serious difficulties now confront the Frei administration, which is eager to forge a strong economic record in preparation for the congressional elections of March 1969 and the presidential election of September 1970. Frei may be able, through various expedients, to avoid any marked deterioration in the economic situation this year. But if he exercises these options, he will aggravate the problems that his administration will be trying to cope with in 1969-70 -- possibly in the face of even stronger political opposition than at present.

17. After having benefited from an export boom during the first three years of the Frei government, the Chilean economy will soon have to adapt itself to a sharply reduced level of exports. The value of exports other than copper (principally iron ore and nitrates) seems to be leveling off after an impressive expansion during 1964-66 and probably cannot be counted on to offset much of the prospective loss in copper revenues. Whereas the total value of exports rose by more than 40 percent (or about \$265 million) from 1964 to 1967 and may rise several more percentage points this year, it probably will decline by some \$100 million in 1969 and recover only partially in 1970.

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18. Imports can hardly continue to grow at the average annual rate of 20 percent of 1966-67. Indeed, even a 10-percent increase in 1968 would threaten a small trade deficit in contrast to the average surplus of \$53 million during 1964-67. Such an increase nevertheless might be feasible if the administration drew on its small foreign exchange reserves, made increased use of short-term foreign credit, and obtained substantial economic assistance from the United States.

19. Further increases in imports in 1969 and 1970 will be even more difficult -- perhaps impossible -- in view of the expected lower level of copper earnings and continuing debt servicing obligations that will average about \$150 million annually in 1969-70. The Frei administration consequently may be compelled to tighten restrictions on imports, which would tend to depress the rate of economic growth. Under these conditions, failure to curb union demands for higher wages probably would lead to rampant inflation.

20. The administration also will face the problem of continuing budgetary strain -- especially during 1969-70. In its budget projections for 1968, the Chilean government assumed a copper export price of 38 cents and consequently anticipated a decrease in its copper revenues to some \$175 million, compared with revenue exceeding \$200 million in each of the preceding two years. The 45-cent price average that is now judged likely for 1968 will yield revenues of some \$220 million. A large budgetary deficit still is probable in 1968, however, because of the slow growth in other revenues and rapidly rising expenditures.

21. The anticipated drop in the value of copper exports in 1969 would, in itself, cut government revenues from copper by nearly \$100 million (or more than 40 percent) and total government revenues by about 5 percent. Revenues from copper probably will rise in 1970 but will remain much lower than during 1966-68. The Frei administration will have no easy way of adjusting to this fiscal stringency. Cutbacks in public investment would undermine efforts

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to stimulate production and provide more jobs. Reduction of current expenditures would require cuts in government employment and services and/or subsidies, prompting adverse reactions from those affected. But the political risks of growing budget deficits financed with credit from the Central Bank would be no less real. Added to the pressures that have given Chile an average annual increase in prices of about 30 percent during the past five years, along with the prospect of stagnant or declining imports, an expansionary policy could well set off a still more severe inflation that would be detrimental to the Christian Democrats' electoral prospects in 1970.

22. Even if production and consumption grow at modest rates, the administration may receive few political benefits if inflation accelerates. Gains in real income probably would be distributed in such an irregular and capricious way and would be so obscured by the average person's concern to keep up in the wage-price race that the government would be given little credit for maintaining economic momentum. Hobbled by a weak foreign payments position, reluctant to resist the wage demands of the unions, prevented from taking decisive stabilizing action by the opposition-controlled Senate, divided and uncertain about what should or can be done, the Frei government appears to have few alternatives to choose from -- and none that can be depended on to make the economic situation an asset rather than a liability during 1969-70.

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