

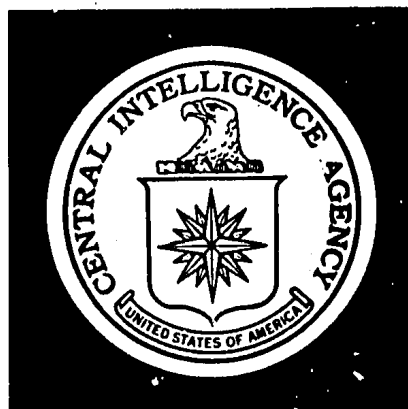
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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*The Chilean Economy: Trends Under Frei
and Prospects for 1969-70*

~~Secret~~

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April 1969

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1969

INTELLIGENCE MEMORANDUM

The Chilean Economy:
Trends Under Frei and Prospects for 1969-70

Summary

In spite of large inflows of foreign aid and favorable export markets, the conditions for economic growth in Chile are less favorable now than in 1964, when the Frei administration took office. The failure to do better economically is largely the result of the high priority given to social reforms and of the problems created by political fragmentation, congressional irresponsibility, and shortcomings in Frei's leadership. Chile has made important social gains under Frei, including:

- a large increase in real incomes of the poorer classes;
- a considerable expansion of social services, especially education; and
- a major start on a comprehensive program of agrarian reform.

Whatever their potential economic benefits, these changes have been so rapid and costly that they have had detrimental short-term effects on the health of the economy. To pay for them, Chile used up most of the proceeds from the increase in foreign economic assistance and the exceptional

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rise in earnings from copper. In addition, incomes had to be diverted not only from the wealthy classes but also from private businesses and farms. Business confidence and profit expectations were in general impaired, and land reform in particular had disruptive effects on agricultural output. Even though tax collections improved substantially, deficit financing of government expenditures was necessary, and the growth of public investment eventually had to be sharply reduced. In consequence, economic trends turned unfavorable:

gross domestic product (GPD) per capita grew moderately fast in 1965-66 but declined in 1967-68;

the pace of inflation first slowed but then speeded up, reaching a rate of 28 percent in 1968; and

private investment has declined since 1964, and total investment has leveled off.

In 1969-70 the Chilean government cannot expect additional revenues from the copper industry, and total output per capita probably will decline because of the current severe drought and the squeeze on private business. A continuation of the rapid social gains of the past few years will therefore not be possible, and real wages may even decline before the presidential election in September 1970.

During Frei's first two years in office, conditions were strongly favorable to the use of fiscal and monetary policies to achieve both price stability and economic growth. A sharp rise in copper prices and the continuation of a high level of foreign aid brought a dramatic improvement in Chile's balance of payments. At the same time, the government's revenues rose rapidly in response to a basic tax reform and the rise in copper prices. The administration initiated a suitable stabilization program and instituted needed reforms in foreign trade and banking, as well as taxation. These reforms were designed to reduce both the rate of inflation and the detrimental effects of inflation on the allocation of resources.

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This promising beginning was undermined mainly by failure to hold wage increases to reasonable levels. Ignoring the administration's guidelines, the Congress granted increases that allowed real wages in the public sector to rise by some 40 percent during 1965-67. Even with a slowdown in the growth of public investment, budget deficits grew, and continued government borrowing from the banking system was necessary. Because of the power of the labor unions and the poor example offered by the public sector, private enterprise was forced to give its workers even more generous wage increases.

The fall in private investment contributed to the slowdown in economic growth during 1967-68. Rising taxes and wages have given costs a continuing strong push and have squeezed the profits of agricultural and industrial producers, most of whose prices are controlled. The cut in profits has been exacerbated by a substantial shortage of credit for the private sector as the government absorbed a large share of available credit under stabilization ceilings. Perhaps most important, investor confidence has been severely eroded by four years of uncertainty concerning land reform policy and by the growing threats against private industry by the leftist element of the Christian Democratic Party (PDC) as well as by Marxist parties.

Chile's economic prospects for 1969-70 are decidedly unfavorable. Already caught in a quandary of economic stagnation with rapid inflation, the Frei administration faces increasing economic difficulties and reduced capabilities to deal with them. The current drought will have adverse effects on output and employment. As a result, the administration will be even more tempted than in the past to follow expansionary fiscal and monetary policies. Moreover, pressures for increased government spending on wages and welfare almost certainly will intensify as the presidential election approaches. Budget and trade deficits are expected to grow in 1969 and 1970 and will be even larger if copper prices decline. A record level of foreign aid probably will cover the bulk of these deficits in 1969, but receipts of aid may decline in 1970. The government thus might have to restrict imports and either cut plans for government spending or resort to

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inflationary financing of a substantial part of the budget deficit.

Under these circumstances, business confidence -- and private investment -- probably will reach a new low during 1969-70, particularly since the powerful leftist faction of the PDC will be competing with other leftist forces in calling for elimination of capitalism during the next presidential term. Increased pre-election clamor for nationalization of foreign companies probably will not prevent continuation of the large investment program by the US copper companies because these investments are guaranteed by the US government; it could, however, further discourage other foreign investments. Government spending probably will be increased in an effort to stimulate the growth of output and maintain employment, even though accelerated inflation will result. Letting the rate of inflation climb to 40 or 50 percent annually would be politically risky and economically irresponsible, but the Frei administration may find it the least unpalatable alternative available.

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Introduction

1. Eduardo Frei Montalva and his Christian Democratic Party (PDC) came to power in late 1964 on a platform of a "Revolution in Liberty" for Chile. In essence, the platform was a pledge to achieve through democratic institutions a far-reaching and dynamic program of socio-economic reform. The new administration faced a number of longstanding economic problems -- inflation, balance-of-payments difficulties, large government deficits, a rate of growth below the nation's capability, and an inequitable distribution of the national income. The Frei administration, however, has had an advantage over preceding governments in its capacity to attack these problems, for two reasons. First, Frei's election to the presidency by an absolute majority of the vote and his party's acquisition, in the 1965 congressional elections, of a majority of the seats in the lower house and a strong minority in the Senate should have reduced some of the political constraints on economic action confronted by earlier coalition governments. Second, world market prices for copper -- the source of the bulk of Chile's export earnings and an important share of tax receipts -- rose by almost 50 percent during the administration's first two years in power and have remained high. Although earnings from copper rose substantially, Chile continued to receive large amounts of foreign aid. Drawings on external loans have averaged about \$250 million annually under Frei.

The Economic Record Through 1968

Growth and Distribution of National Income

2. Although Chile has been favored by high levels of export earnings and foreign aid, the rate of economic growth during the past four years has been less than the average for Latin America and has been no better than that achieved under the preceding, conservative government of Jorge Alessandri (1958-64). Chile's rate of growth has been held down by Frei's pursuit of such social objectives as agrarian reform and more equitable distribution of income. Some of the costs of these social programs were willingly assumed by the administration. Others have been thrust upon it because of the rising tide of economic demands

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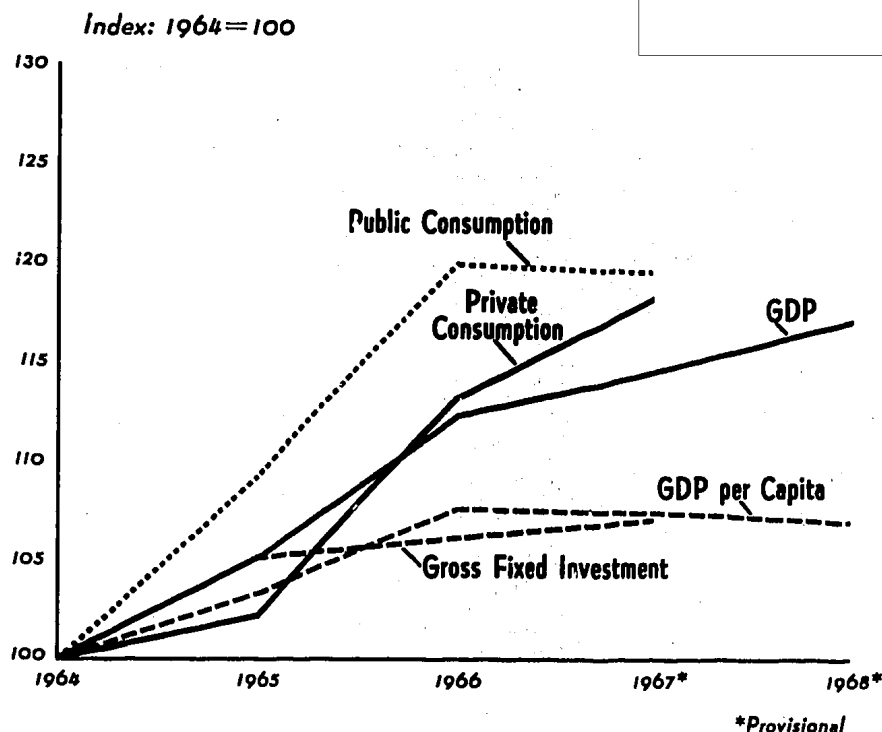
and political pressures that its "revolutionary" program unleashed.

3. Annual increases in GDP averaged roughly 4 percent during Frei's first four years, or somewhat less than 2 percent per capita. Thanks to a sharp rise in consumer demand and public investment, GDP grew by 5 percent in 1965 and almost 7 percent in 1966. Strike difficulties in the mining sector and a slowdown in manufacturing and construction activities brought an early end to the boom period, however. The rate of economic growth in 1967 fell to about 2 percent, and the final results for 1968 are expected to show little if any improvement over that low rate. By comparison, economic growth during the last four years of the Alessandri administration averaged about 5 percent annually. This is the only period for which fully comparable data are available, but it is apparent that, under both Alessandri and Frei, the Chilean economy surpassed the long-term growth rate of about 3.5 percent that was achieved from 1940 to 1960.

4. During Frei's first two years, Chile's gross domestic income (defined as GDP in real terms plus changes in the terms of trade) grew more rapidly than its GDP because of rising world prices for copper. Gross domestic income expanded by more than 17 percent during these two years, compared with the 12-percent increase in GDP. Expansion in income adhered more closely to the rate of growth in total output during 1967-68, as copper prices leveled off.

5. Under the Frei administration, private consumption has increased somewhat more rapidly than GDP and much more rapidly than investment (see the chart). Underlying the rise in private consumption was a large increase in wage income, which made up 54 percent of GDP in 1967, compared with 47 percent in 1964. Lower income groups have experienced gains in their living standards as a result of both the substantial increase in real wages and the expansion in social services under the Frei administration. While the poorest workers have benefited from these policies, organized labor probably has gained proportionately more, since the unions have had the power to obtain even larger raises in wages. Other people who supported the PDC in the 1964 election -- from among such groups

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as owners of large and middle-sized farms, private businessmen, and the wealthy class in general -- have lost ground since Frei's advent. Even many of those who have gained the most probably expected more of the new government or feel that they would have done better under an openly Marxist government. The losers, on the other hand, almost certainly attribute their misfortune to the policies of the Frei administration.

6. The Frei government has dramatically increased the share of resources allocated to the public sector. Public consumption rose much faster in volume than GDP until 1967, when the continued rapid increase in the public wage bill restrained new hirings and goods purchases. Because increases in public investment were partly offset by reductions in private investment, the growth of total investment lagged well behind that of GDP. During the period the public sector has become far more important than the private sector in capital formation. This change is reflected partly in the increased role of public entities as direct investors and partly in the growing tendency of private investments to be financed with funds obtained from the public sector.

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Public investment expenditures, including government loans for private investment in specific industrial projects, rose from 48 percent of total gross domestic investment in 1963 (the last normal, pre-election year) to 71 percent in 1967. During the same period, the public sector's direct expenditures for fixed investment rose from 40 to 55 percent of total fixed investment.

Private Capital in a Mixed Economy

7. The Frei government's objective of increasing the public sector's importance in the economy thus has discouraged private investment and led to a reduction in share of total investment in GDP.* The PDC's economic policy assigned to the government a leading role in assuring an increased flow of funds into the development of selected industries as well as into agrarian reform, education, housing, and other programs designed to improve the welfare of lower income groups. With some justification, the PDC held that the flow of private resources into these areas had been inadequate and needed to be supplemented by the government. President Frei and his more conservative supporters within the party recognized the continued importance of private investors, however, and tried to encourage their participation in the task of economic development despite the government's larger economic role.

8. In practice, however, government policies have discouraged private investment. Ever-increasing financial demands from both government and labor have cut severely into private profits and dampened profit expectations. The terms of

* The ratio of gross fixed investment to GDP during the first three years of the current administration averaged about 15 percent, compared with an average of 17 percent during the last four years of the Alessandri government. Previous estimates of national income had indicated an average ratio of investment to GDP of 12 to 13 percent for the 1960's. During the last two years, however, Chilean Planning Office has completely revised the statistics for the period 1960 to 1967. Although the new accounts probably are an improvement over earlier estimates, basic data still are fairly unreliable, particularly in regard to private investment and personal consumption.

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trade for agriculture improved somewhat during 1965 and early 1966 (though the gain was partly offset by rapidly rising labor costs), but they began to deteriorate again by late 1966. During the past two years, real agricultural prices continued their decline, and the profit squeeze tightened because farmers bore the brunt of administration efforts to stem the accelerating rise in the cost of living. In private business activities outside of agriculture, savings have declined (in real terms) throughout the period. Profits have been squeezed because prices were controlled while costs were rising rapidly as a result of substantial increases in taxes and wage raises far in excess of productivity gains.

9. Industrial expansion also has been impeded by a severe tightening of credit, except for a few projects being promoted by the government. Bank credit to the private sector has been restricted within the limits established by the government's borrowing needs on the one hand and the ceiling imposed by the International Monetary Fund (IMF) on overall credit expansion on the other. During 1965 and 1966, manufacturers generally were able to respond quickly to the increase in consumer demand accompanying the rise in wages and thus to partially offset narrowing profit margins through increased sales volume. Some manufacturing firms had reached their capacity levels by 1967, however, and subsequently were unable to expand operations because of the credit squeeze. Other industries have encountered more complex problems since 1966 because the slackening in the overall rate of economic growth, a substantial decline in construction activity, and marked shifts in consumer preferences have reduced effective demand for their products. These firms have been confronted simultaneously with declining sales, rising costs, and restricted credit. Many industries also have been increasingly affected by strikes, which caused the loss of 2 million man-days of work in 1967 and 4½ million man-days in 1968.

10. Investor confidence has been further eroded by uncertainties concerning land reform policy and by repeated threats against private industry (including the threat of nationalization) that have emanated from the more leftist elements within the PDC as well as from openly Marxist forces. Private

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investments have been restricted mainly to a few industries (such as petrochemicals, paper, cellulose, and steel) to which the government is heavily committed and has been willing to provide capital. Thus political uncertainties and the squeeze on profits and credit have relegated private capital to a less important role than the Frei faction of the ruling party had initially intended.

11. The interest of potential foreign investors apparently also has been dampened by the changed environment for private enterprise. A World Bank mission to Chile in the summer of 1968 found little private foreign capital entering the country other than for the copper companies' expansion program (insured under the US investment guaranty program) and a few major investment projects arranged some time ago.

Fiscal Control and Public Investment

12. The Frei government, favored by a rapid growth of revenues, has succeeded in reducing the ratio of the budget deficit to total expenditures but not the amount of the deficit in real terms (see Table 1). The ratio of the budget deficit

Table 1

Revenues and Expenditures
of the Consolidated Public Sector

	<u>Million 1967 Escudos</u>			<u>Deficit as a Percent of Expenditures</u>
	<u>Revenues</u>	<u>Expendi- tures</u>	<u>Deficit</u>	
1964	7,267	8,367	1,100	13.1
1965	8,849	10,246	1,397	13.6
1966	10,592	11,811	1,219	10.3
1967	12,344	13,393	1,049	7.8
1968 (Pro- visional)	13,259	14,518	1,259	8.7

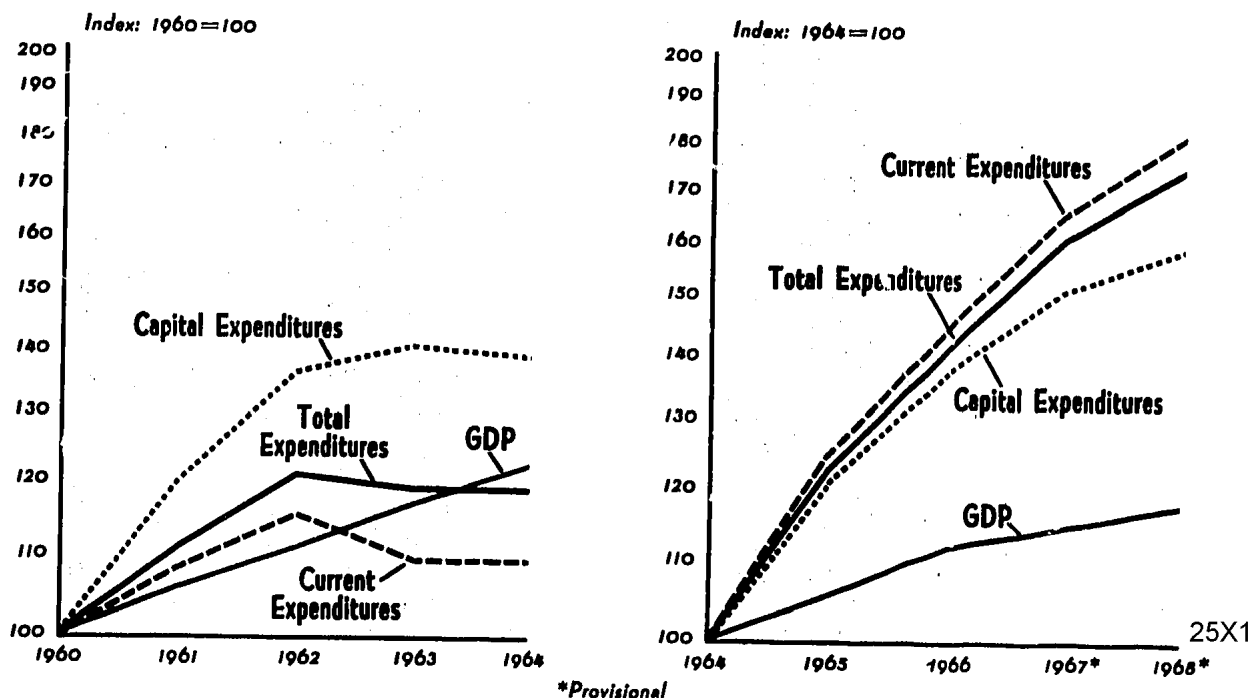
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to total expenditures of the public sector declined from about 13 percent in 1964 to 8 percent in 1967 and about 9 percent in 1968. The deficit in 1968 still equaled about one-third of public investment expenditures compared with about one-half in 1964.

13. During 1965-66, revenues grew in real terms by almost 60 percent for the central government and by more than 45 percent for the public sector as a whole. Revenue yields from the rapidly rising profits of the copper companies doubled during this period and provided about 17 percent of central government revenues in 1966. Extension of the tax reform initiated under the previous administration brought a 55-percent increase in other income taxes and property taxes during Frei's first two years in office. Indirect taxes grew by almost 50 percent during this period because of an improvement in the system of tax collection as well as the increase in economic activity. During 1967-68, economic growth slowed and copper prices leveled off, holding the annual increases in central government revenues to only 10 percent in real terms, compared with the 26-percent annual average in 1965-66. By 1967, taxes (including social security contributions) had increased to more than 30 percent of GDP -- a high ratio by almost any standard.

14. The Frei administration allowed the total expenditures of the public sector to rise by about 75 percent in real terms during 1965-68 in sharp contrast to the moderate initial increases and subsequent declines in expenditures during the preceding four years. As a ratio of GDP, total public spending rose from 35 percent in 1964 to about 45 percent in 1968. The difference in the growth of current expenditures during the two periods was even more pronounced, as shown in the chart. Annual increases in public investment expenditure dropped from an average of 20 percent in 1965-66 to about 10 percent in 1967 and 5 percent or less in 1968 -- thereby providing an element of budgetary restraint during the past two years. For the period as a whole, public investment rose by about two-thirds while private investment fell.

15. Under Frei, public investment has continued to be concentrated on transportation and electric power facilities and on housing, education, and other social welfare projects. During 1965-67, less than one-sixth of public investment (including publicly financed private investment expenditure)

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was devoted to industrial and agricultural projects. Government investment spending thus has done little to offset the depressing effect of the administration's economic policies on private investment in these fields.

16. In its program for 1960, the Frei administration launched a courageous, but belated, battle for a more restrictive fiscal policy. The most important expansionary forces behind the rapid rise in current expenditures by the central government during 1965-67 were a 53-percent increase in the real wage bill and a 51-percent increase in real terms in current transfers to decentralized agencies (in part necessitated by the increase in their wage bills). In view of the increasing inflation and decreasing rate of growth, the need for greater restraints on current expenditures was evident. Frei therefore introduced into Congress a wage readjustment bill for public employees that would hold increases in cash income in 1968 to 75 percent of the cost-of-living rise in the preceding year and pay the other 25 percent in bonds issued

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against a newly created national investment fund. By this time, however, the President not only had little influence among the opposition in the Congress but also had lost control over a large portion of his own party. The "compromise" bill that finally emerged from the Congress after six months' delay and the resignation of two Finance Ministers contained none of the savings features of the original and permitted an average increase of about 38 percent in wages -- far in excess of the 22-percent rise in the cost of living the previous year.

17. The sharp increase in the budget deficit over the level originally planned for 1968 was covered partially by requiring "prepayment" of corporate and personal income taxes -- in effect, a forced loan (to be repaid in 1970) which was extended to include the US copper companies as well as Chilean taxpayers. In addition, the administration successfully negotiated for resumption of budgetary support from the United States in the form of a \$20 million program loan drawn on during the latter half of 1968. Despite these additional sources of revenue and the trimming of investment expenditures, deficit financing through domestic borrowing continued to be necessary in 1968.

Agricultural Development and Reform*

18. Although Frei's ambitious agrarian reform program has partly achieved its social and political objectives, it has not been successful thus far from an economic standpoint. It is still too early to judge whether the program ultimately will contribute to the solution of Chile's longstanding agricultural problems. It is clear, however, that had the program been motivated predominantly by economic considerations, less costly and more expeditious ways of strengthening production incentives, encouraging investment, utilizing land more effectively, and improving farm technology would have been adopted. Chile continues to be increasingly dependent on imports of foodstuffs, about

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three-fourths of which could be produced domestically if the agricultural sector were more efficient. Net imports of food had risen to about \$120 million annually before the current drought became a factor contributing to the inadequacy of domestic production.

19. The Frei administration had hoped to minimize the adverse impact of land reform on the existing landowners by establishing the guidelines and schedule for expropriation promptly and clearly and by substantially improving terms of trade for agricultural producers. The new, stronger land reform law desired by Frei took more than two years to pass through Congress, however, meeting opposition from both rightist and leftist forces. During the 18 months since its enactment, conflict within Frei's own party concerning the pace and goals of reform has deepened the feeling of uncertainty among private landowners. During its first two years, the administration did succeed in increasing agricultural prices in real terms*; in 1966 they averaged 13 percent above their 1964 level. Since late 1966, however, these prices have been declining. By the end of 1968 they had slipped back to about the 1964 level. The costs of agricultural production have climbed steeply throughout the period since 1964. Wage costs in particular have soared, largely because of the success of the unionization movement sponsored by the government. Although precise data are lacking, agricultural production apparently is even less profitable now than it was prior to the Frei administration, and private investment has fallen.

20. At a heavy cost in money and some disruption of agricultural activity, about 4 percent of the total land in farms was acquired for redistribution between the end of 1964 and mid-1968. About four-fifths of this land has been incorporated into some 270 cooperative settlements managed by the Agrarian Reform Corporation (CORA). Although less than half of the land acquired thus far was expropriated, involvement of radical members of the PDC in the administration of the reform has made it more damaging economically and more abrasive socially than it needed to be. Carried out in

* *Prices received by producers of agricultural products, deflated by the increase in the consumer price index.*

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the spirit of a "revolution in the countryside," the program probably has depressed output in some areas most heavily affected by agrarian reform activities. It has not, however, prevented moderate gains in output for the country as a whole. All of the gain in total output has come from sharply increased livestock output. Crop production, which has been more directly affected by land redistribution and lower prices, has declined since 1964.

21. During the first two and one-half years of the Frei administration, CORA acted under the land reform law of 1962 and acquired 1 million hectares for redistribution -- about half of it from publicly owned lands. Since enactment of the new land reform law in July 1967, almost all of the land acquired has been expropriated. By 31 May 1968, CORA's acquisitions amounted to some 1,250,000 hectares, including almost 15 percent of Chile's total irrigated area and 30 percent of the irrigated land in the richest agricultural area, in the provinces surrounding Santiago.

22. The original target for land redistribution was to settle 100,000 families during 1965-70. but in 1967 the goal was revised downward to 60,000 families. By mid-1968, only about 9,000 families had been settled. In view of the recent rate of progress, settlement of 35,000 families by 1970 would be a more realistic goal. The program apparently is being hindered mainly by financial difficulties. Total government expenditures on agrarian reform are not known, but reported public investment expenditures channeled through CORA (which may include large amounts of current expenditure) have amounted to almost \$100 million during the past four years. These expenditures by CORA have now increased to about 5 percent of total public investment. According to CORA's own estimates, the costs for resettlement average \$11,000 per family.

23. Much controversy has developed in Chile concerning the net costs of the land reform and the viability of the new cooperative settlements, in part because CORA has refused to make public the balance sheets of the newly organized farms. It is clear that the land reform costs are far in excess of the government's original estimates.

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Even the reduced goal adopted in 1967 places a significant financial burden on the government.

24. Landholders and other Chileans holding traditional views regarding property rights are greatly disturbed by the confiscatory nature of the land reform effort. Expropriated properties are valued at their assessed value for tax purposes, which generally amounts to only about 50 percent or less of their market value. Cash payments for the expropriated land are small -- only 1 to 10 percent of the price paid. The remainder is paid in 25- to 30-year self-liquidating bonds that carry a 3 percent interest rate and will be adjusted in value periodically to reflect 70 percent of the change in the cost of living.

Other Social Welfare Programs

25. The Frei administration has initiated an 8- to 10-year program to reform the public education system and has given it high priority. About 6 to 7 percent of public investment expenditures are being channeled into construction of school facilities (compared with an average of 4 percent during 1961-64), and educational expenditures represent about one-fifth of the government's total current expenditures. The US Agency for International Development (AID) has provided two loans totaling \$26.3 million for education and has proposed additional loans for education of at least \$60 million during 1968-71. Substantial progress already has been made in expanding school facilities and, in particular, in increasing educational opportunities for low-income groups while improving the quality of their instruction.

26. Although housing continues to absorb some 25 percent of total public investment spending, achievements have been less satisfactory in this field than in education. During the 1964 campaign, Frei promised a housing program of 360,000 new starts by 1970, or an average of 60,000 annually, compared with an average of 30,000 annually during the Alessandri administration. At the end of three years, only about one-third of the goal had been met, and the Frei administration announced a new target for low-income housing. The revised program embraces new starts on the construction of permanent houses and temporary dwellings and the mere provision

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of urban sites -- some with construction materials to be used on a self-help arrangement. On this basis, the administration may well be able to claim overfulfillment of its targets, particularly in view of the fact that the Housing Ministry since 1967 has been able to expropriate urban land at a fraction of its market value.

27. The Frei administration is committed to the expansion of public health care facilities, particularly in urban slums and rural areas, and to the provision of free health care through the National Health Service (SNS). Expenditures on construction of health facilities increased substantially in real terms during 1965-67 but continued to account for only about 2 percent of public investment expenditure, as under the Alessandri administration. Between 1964 and mid-1967, 33 new hospitals and 62 polyclinics and health centers were completed. The SNS receives more than 40 percent of the central government's current transfers to the public sector, or about 10 percent of total current expenditures by the central government. Nevertheless, the SNS is encountering increasing financial difficulties, and the quality of its health services continues to suffer from deficiencies in facilities, supplies, and manpower. Real improvement probably can come only with a basic reform of the social security system, contributions from which currently cover less than 5 percent of the SNS budget.

28. Frei's efforts to revamp Chile's chaotic social security system have been unsuccessful so far. The system consists of 44 insurance funds (*cajas*), all operating as independent, quasi-government agencies under more than 400 laws. Social security tax rates on payrolls -- paid by both employers and employees -- are very high (47 percent or more of wages), but revenues still are inadequate -- in part because the taxes are evaded. The results have been very wide disparities in pensions, family allowances, and the many other benefits offered and an increasing drain on public resources. President Frei empowered a committee to draw up recommendations in 1966 and submitted a reform bill to Congress in September 1968, opposition to which was immediate and loud. The most likely outcome, as the presidential election approaches, is a further addition of benefits to

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an already overburdened system that may well collapse before it is renovated.

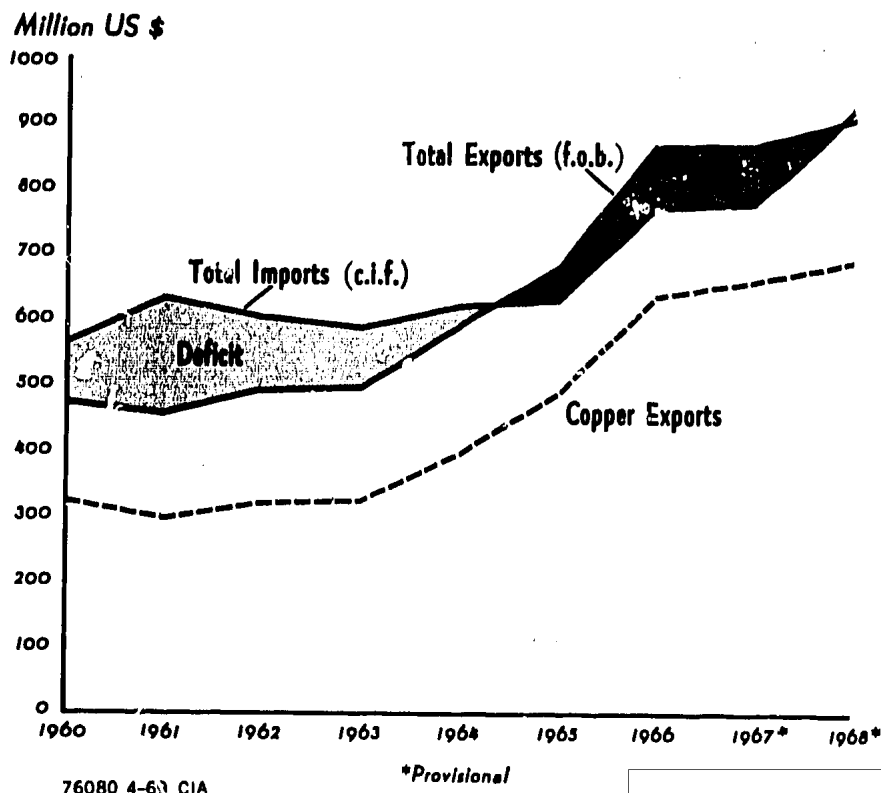
Balance of Payments

29. The Frei program has benefited from a dramatic improvement in Chile's balance of payments since 1964. The fortuitous rise in world copper prices combined with an increasingly high level of external aid permitted the replenishing of foreign exchange reserves, repayment of a large amount of short-term commercial arrears, and -- perhaps most important -- the relaxation of the severe restrictions on imports that had restrained growth and added to inflationary pressures throughout the early 1960's. Chile's terms of trade improved by a remarkable 56 percent between 1964 and 1966 -- largely because of a rise of almost 50 percent in copper prices and some reduction in import prices. At the same time, gross receipts of foreign aid, mainly from the United States and international financial organizations, averaged about \$240 million a year during 1965-66.

30. The growth in export earnings averaged 21 percent annually in 1965 and 1966, almost entirely because of the rise in copper prices. The value of copper exports in 1966 was almost \$250 million higher than in 1964 and represented nearly 75 percent of total export earnings compared with about 65 percent in 1964. The Alessandri and Frei governments used severe exchange and trade restrictions to hold imports at or below their 1961 level through 1965. In 1966, improvement in the balance of payments permitted a relaxation, and imports rose by 25 percent. Although capital equipment and raw materials accounted for the major portion of the increase, imports of foodstuffs and durable consumer goods rose by 19 and 16 percent, respectively. Imports were not permitted to absorb all of the increase in export earnings, however. In 1966, as in 1965, Chile achieved trade surpluses in contrast to the chronic deficits of the early 1960's (see the chart).

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31. By devaluating the escudo at a faster rate than the rise in the consumer price index, the Frei administration has tried to improve the competitive position of export items other than copper. Production costs in these industries probably have risen considerably faster than the rate of devaluation, however, and the crisis of confidence affecting private investment as a whole has deterred expansion in some export industries as well. As a result, exports other than copper increased only from \$199 million in 1964 (one-third of total exports) to \$221 million in 1968 (one-fourth of total exports).

32. Because little progress was made in diversifying exports, the expansion in the total export earnings halted in 1967, when earnings from copper exports leveled off. At the same time, the deficit on current account widened as a result of a larger net outflow for services which consist mainly of interest payments and profit remittances (see Table 2). Despite the rise in direct investments deriving mainly from the copper expansion program,

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Table 2
Chile: Balance of Payments

	Million US \$								
	1960	1961	1962	1963	1964	1965	1966	1967 Provi- sional	1968 Provi- sional
<i>Balance on current account</i>	-160	-264	-202	-199	-132	-55	-71	-119	-212
Trade balance	-97	-173	-112	-89	-32	52	83	81	-16
Services and transfers	-63	-91	-90	-110	-100	-108	-154	-200	-196
Interest payments	-23	-32	-39	-43	-40	-66	-74	-73	-85
Profit remittances	-53	-45	-51	-47	-63	-60	-111	-136	-120
Other services	-14	-33	-13	-25	-5	8	18	1	-7
Transfers	27	19	13	5	8	10	13	10	16
<i>Balance on capital account</i>	50	137	168	139	160	120	165	130	345
Direct investment (net)	45	49	33	-26	8	-4	19	52	166
Drawings on foreign loans	54	171	208	227	241	217	259	210	314
Official credits	14	98	135	185	198	173	203	160	274
Private sector supplier credits	40	73	73	42	43	44	56	50	40
Amortization of foreign loans	-49	-83	-73	-62	-89	-93	-113	-132	-135
Official credits	-32	-50	-38	-29	-56	-49	N.A.	N.A.	-77
Private sector supplier credits	-17	-33	-35	-33	-33	-44	N.A.	N.A.	-58
<i>Errors and omissions</i>	68	-8	-40	38	-4	-4	28	-28	-6
<i>Change in net foreign reserves</i> (- = increase)	42	135	74	27	-24	-60	-122	28	-127

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the net inflow on capital account dropped in 1967 because of Frei's decision to forgo US budgetary support in an attempt to induce more responsible fiscal measures by the Chilean Congress. Chile consequently suffered a small loss in foreign exchange reserves.

33. In 1968 the net outflow for services decreased somewhat (mainly because rising production costs and the obligatory "prepayment" of Chilean taxes cut into net profits remitted by US copper companies), but Chile's trade account slipped into deficit for the first time since 1964. Although world copper prices unexpectedly rose above the already high level of 1967, labor strikes during the first half of the year and drought-induced production difficulties at the end of the year restricted the volume of exports. The total value of exports in 1968 thus increased by less than 5 percent while imports rose by almost 18 percent. As a result, the current account deficit grew by about \$100 million in 1968. The continued expansion of direct investments and a record inflow of foreign assistance, however, were more than sufficient to offset the imbalance. Direct investments by the US copper companies totaled \$135 million. Drawings on foreign loans, mainly from the US government and international financial organizations, reached an all-time high of \$314 million. As a result, Chile's net foreign reserves improved by an estimated \$127 million during 1968.

34. Chile has been one of the leading recipients in the world of US economic aid. During the first four years of the Frei administration, this aid totaled some \$650 million. In Latin America, Chile holds first place in the amount of assistance received per capita and is second only to Brazil in the total amount received. US support presumably was instrumental in Chile's acquisition of more than \$200 million in additional economic assistance from international financial organizations during 1955-67.

35. Although Chile's foreign debt increased by nearly \$1 billion during 1965-68, the burden of debt servicing did not increase proportionately. One of the major campaign issues in 1964 was the heavy load of foreign debt that Chile had built up through extensive use of suppliers' credits during the late 1950's and early 1960's. Shortly after its inauguration, the Frei administration successfully sought a rescheduling of debt servicing

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obligations falling due in 1965 and 1966 and agreed to strict limits on the use of short- and medium-term suppliers' credits. The structure of Chile's foreign debt has been further improved by the more favorable terms available for US aid since the initiation of the Alliance for Progress. Chile has been one of the principal recipients of "soft" loans under this program.

36. By the end of 1968, Chile's total foreign debt amounted to an estimated \$2.6 billion, or more than three times the average annual export earnings during 1965-68. Almost all of the increase in debt during this period represented liabilities of the public sector, as shown in the following tabulation:

	<u>Billion US \$</u>				
	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>
Public debt and government-guaranteed private debt	1.2	1.3	1.6	1.9	2.1
Other known private debt	0.5	0.5	0.4	0.5	0.5
<i>Total foreign debt</i>	1.7	1.8	2.0	2.4	2.6

The ratio of servicing obligations* to total export receipts varied between 22 and 24 percent during 1965-68. This ratio may increase to as much as 30 percent in 1969, however -- mainly because amortization payments on public foreign debt are scheduled to increase. Although debt repayments are expected to continue at a high level over the next several years, the servicing ratio may be lower after 1970-71, when completion of the copper expansion program will permit an increased volume of copper exports. Nevertheless, as a condition for the extension of a standby loan for 1969-70, the IMF has required ceilings on additions to Chile's foreign debt that must be repaid in less than 15 years.

* *Amortization and interest on public foreign debt (excluding liabilities of the Central Bank), government-guaranteed private debt, and known private debt.*

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SECRETPace of Inflation

37. Failure to slow the pace of inflation is one of the most important economic shortcomings of the Frei administration and a highly damaging matter politically. The basic cause of the failure is the collapse of the government's wage policy in the face of intense opposition from the left, including some factions of the PDC. This opposition has made a shambles of the stabilization policy that Frei announced shortly after his inauguration.

38. The new stabilization policy was designed to end inflation over a period of four years, reducing the rate gradually so that increased unemployment and economic recession might be avoided. In order to gain the public's confidence that a consistent "war on inflation" would be waged, the government widely publicized its commitment to specific goals. The program called for reduction of increases (end-of-year basis) in the consumer price index from 38 percent in 1964 to 25 percent in 1965, 15 percent in 1966, and 10 percent in 1967 and for relative price stability from 1968 on. Wages were to be adjusted annually in line with the rise in the cost of living during the preceding year, which under conditions of decelerating inflation would permit increases in real wages. At the same time, the government intended to foster changes in relative prices to correct distortions.

39. Frei's program was an appropriate, encouraging response to the economic problems that Chile then faced. Moreover, the dramatic improvement in the balance of payments and the sharp increase in government revenues during the first years of the Frei administration were strongly favorable to the use of fiscal and monetary policies to achieve both price stability and economic growth. The administration did manage to take some steps designed to reduce both inflation and its detrimental effect on the allocation of resources: it strengthened the tax system, liberalized import controls, adopted more flexible exchange rates, and provided for adjustments in savings accounts to reflect the increase in prices.

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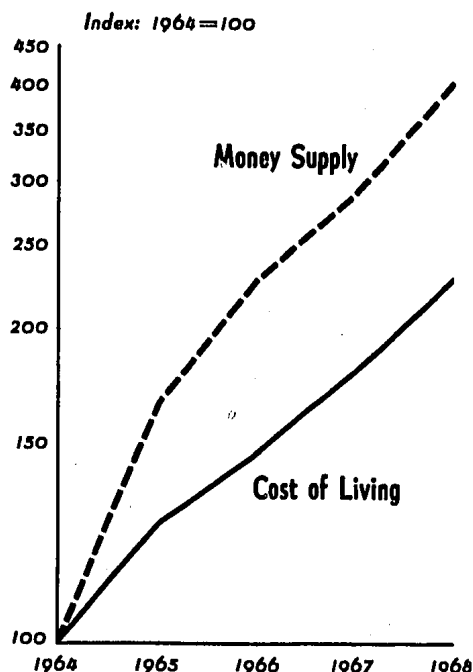
40. These gains were overshadowed, however, by the administration's inability to hold down wage increases. A large part of the blame must be attributed to Frei's failure to exercise strong leadership early in his term, when his influence in the Congress was at its height and the range of palatable options at its broadest. The Congress sabotaged the stabilization effort mainly by passing bills allowing wage increases far in excess of the administration's guidelines. As a consequence, real wages in the public sector expanded by some 42 percent during 1965-67. The large increases given to public employees made it impossible to balance the budget. They also made it increasingly difficult for the private sector to observe the administration guidelines, and real wages in private employment rose at even a faster rate.

41. The government's financial problems led to neglect of productive investment and required borrowing from the banks, which restricted credit available to private business. Large wage gains and tax increases boosted costs in the private sector, stepping up inflationary pressures and putting a cost-price squeeze on some firms that discouraged investment and contributed to the slowdown in economic growth. Through its tax, price, and wage policies, the administration encouraged a redistribution of national income toward wage earners that has fundamentally altered the attractiveness of business enterprise in Chile.

42. Despite worsening inflationary pressures from accelerated government spending, rapidly rising real wages, and a large expansion in the money supply (65 percent in 1965 and 39 percent in 1966), the government managed to adhere fairly closely to its price targets during the first two years of the stabilization program. Prices rose by 26 percent in 1965 and 17 percent in 1966. This achievement, however, was largely the result of price controls and emergency measures. In September 1966, when the cost-of-living index already had risen 21 percent above the level of December 1965, the government fell back on extraordinary food imports, direct control of the wholesale vegetable market, and other emergency measures to drive the index down closer to the planned level. In 1967 the combination of pent-up demand, rising real costs,

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and stagnating output was too strong for price controls to be effective, and the cost of living rose by 22 percent. Excessive monetary expansion during 1968 resulted from the government's worsening financial position and added significantly to the upward pressure on prices (see the chart). By August the cost of living had risen 26 percent, and the increase for 1968 as a whole



was held to 28 percent only through emergency efforts to depress food prices during the last quarter. In January and February 1969 the cost-of-living index rose by almost 11 percent.

Economic Prospects for 1969-70

43. Chile's economic prospects for 1969-70 are distinctly unfavorable. At the end of four years in office, the Frei administration is caught in the quandary of economic stagnation and inflation -- to which there are no

happy solutions. In addition, the government faces

serious problems as a result of the severe drought and the expected stagnation or decline in copper prices. As the presidential elections approach, moreover, pressures for government spending on wages and welfare almost certainly will intensify, further straining budget resources and accelerating inflation. Business confidence probably will reach a new low, thus further slowing the growth of investment and output. The trade deficit is expected to reach a record level in 1969 and remain large in 1970. One bright spot in the picture is the likely expansion of foreign assistance, at least in 1969. Another important favorable factor is the \$530 million copper

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expansion program, four-fifths of which is being financed by the US copper companies (whose investments are insured under the US investment guaranty program). But it is possible that these companies will be expropriated even before the scheduled completion of the expansion program in 1971.

44. In part, the economic outlook is bleak because the chances for positive government action seem slim. Frei will be a lame duck during 1969-70 and will have even greater difficulty than in the past in forging majorities for measures of economic readjustment. Considering what the administration accomplished when luck was on its side, it is difficult to expect much from it as major problems build up in the midst of an election campaign. Even without the drought problem, per capita output probably would not have grown in 1969, and the inflationary spiral would have been politically difficult to curb. If the drought eases during 1969, GNP should recover partially in 1970, but the population will still have much cause for dissatisfaction with the economy. To minimize the extent of recession and unemployment, the administration during the next two years will be strongly tempted to employ expansionary fiscal and monetary policies -- as it has in the past under far less trying circumstances. This approach could increase the rate of inflation to as much as 40 or 50 percent annually, which would be both economically irresponsible and politically risky. The administration may, however, decide to gamble on the preservation of a false sense of prosperity rather than to "tell it like it is" to people on their way to the polls.

45. Chile's drought -- the worst in 44 years -- is badly disrupting output in the most important agricultural region. Total agricultural output probably will drop by 20 to 30 percent in 1969. Through its impact on agricultural output, the agricultural processing industries, hydroelectric power supplies, and large industrial users of power, the drought could cause a decline of 5 to 10 percent in GDP per capita. This misfortune also will aggravate budget and balance-of-payments problems, increase unemployment in both rural and urban areas, strengthen inflationary pressures, and heighten popular unrest. Electric power output should

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largely recover in 1970, if precipitation is normal in mid-1969. But agricultural production will continue to suffer from inadequate soil moisture, damaged orchards and vineyards, and depleted livestock herds.*

46. The prospective stagnation or decline in the world price for copper may bring a decline in export earnings in 1969-70 from the unusually high levels of 1965-68. Under the best of circumstances, it is unlikely that export earnings will be an important factor in the growth of national income, as they were during the early years of the Frei administration. Inasmuch as the drought is reducing supplies of hydroelectric power and water (which is needed for ore concentration), production and exports of copper in 1969 probably will be lower than had been projected. The scheduled expansion of the industry may allow export earnings in 1970 to be restored only to the level of 1967-68. Export capacity is being developed in such industries as steel, cellulose, paper, and petrochemicals. However, because of the time needed for completion of these projects, there probably will not be any significant diversification of the export structure during 1969-70.

47. The combined impact of reduced export earnings and expanded imports could raise Chile's trade deficit to a record high of about \$250 million in 1969. Assuming a further reduction in profit remittances by US copper companies, the net outflow for services should decline somewhat. Nevertheless, Chile's deficit on current account in 1969 may amount to about \$430 million -- or about one-half of total export earnings. US aid to Chile is expected to increase in 1969, despite the large US Congressional cut in total aid to Latin America. At the end of 1968, AID estimated that drawings on foreign loans and direct foreign investment (mainly by the US copper companies) would approximate \$600 million in 1969. Such an inflow of capital would be sufficient to cover the prospective deficit on current account and finance scheduled debt repayments (see Table 3).

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Table 3

Projected Changes in Balance of Payments
from 1968 to 1969

	Million US \$	
	1968 Provi- sional	1969 Projected
<i>Balance on current account</i>	-212	-430
Trade balance	<u>-16</u>	<u>-252</u>
Exports (f.o.b.)	910	856
Imports (c.i.f.)	-926	-1,108
Services and transfers	<u>-196</u>	<u>-178</u>
Interest payments	-85	-83
Profit remittances	-120	-106
Other services	-7	-5
Transfers	16	16
<i>Balance on capital account</i>	345	432
Direct investment (net)	<u>166</u>	<u>190</u>
Copper expansion program	135	169
Other investment (net)	31	21
Drawings on foreign loans	<u>314</u>	<u>417</u>
Official credits	274	382
Private sector supplier credits	40	35
Amortization of foreign loans	<u>-135</u>	<u>-175</u>
Official credits	-77	-118
Private sector supplier credits	-58	-57
<i>Errors and omissions</i>	-6	0
<i>Change in net foreign reserves</i> (- = increase)	-127	-2

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48. In 1970, however, the Frei administration may find it more difficult to avoid serious balance-of-payments problems and a return to stricter import and exchange controls, despite their negative effect on both price stability and economic growth. If normal weather returns and the copper expansion program proceeds as scheduled, Chile probably will be able to reduce its trade deficit in 1970, though not necessarily to the level of 1968. The net outflow of funds for services and amortization payments on foreign debt is expected to increase. Although Chile's gross foreign exchange reserves reportedly increased to somewhat more than \$200 million at the end of 1968, foreign capital will continue to be needed to cover these outflows. Chile probably will continue to have a high priority for US aid, but the US government may not be able to respond fully to Chilean financial needs in 1970 if the US Congress does not raise the overall ceilings on aid to Latin America. Moreover, increased pre-election clamor for new agreements with the US copper companies or for nationalization of the properties could have an adverse effect on the level of US aid and possibly slow the inflow of direct investments.

49. Prospects for fiscal and monetary stability also are unfavorable. In an attempt to avoid the wage readjustment debacle of 1968, the Frei administration included its wage readjustment legislation in the 1969 budget bill. As submitted, the legislation provided for a general increase of only 22 percent in public sector wages, but special raises authorized (but not fully paid) last year will bring the overall rise in the public sector wage bill to 38 percent. The budget assumes the receipt of food imports under PL 480 that total \$40 million. The proceeds in escudos from the sale of these imports are to be used for drought relief and are the only amount provided for this purpose in the budget. No provision is made for the additional \$43 million in debt servicing payments required for 1969 or for about \$40 million in new investments originally planned for next year. On this basis, the budget contains a deficit of \$48 million, which the administration proposes to finance through reimposition of the wealth tax and continuation of the forced loans from the US copper companies and other

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corporations. Implementation of administration plans for additional expenditures not included in the budget submitted to the Congress would increase substantially the size of the deficit. The administration is counting on enlarged program loans and other budget support from the US government as a major source of financing.

50. In view of its past performance and the upcoming elections, the Congress can be expected to attempt to expand the budgeted level of current expenditures, particularly for wages. Chilean politicians, including members of the PDC, already are studying means of financing an additional wage increase in 1969. It will be politically difficult for the administration to defend the need for a general wage increase below the level of last year's rise in the cost of living. Public investment expenditures probably can be cut little without a negative impact on politically important welfare projects and on employment levels. If Chile does not hold budget expenditures and monetary expansion within certain limits, however, continued receipt of budget support aid from the United States and drawings on standby credits from the IMF could be endangered. The added inflationary pressures that would result from domestic financing of a budget deficit substantially larger than that originally planned also present very serious political risks. Pressures for wage raises in the private sector, which will be very difficult to withstand, are likely to result in a further increase in the pace of inflation. In sum, it appears that the administration will have to choose among several unpalatable alternatives -- any one of which will tend to cancel out the political advantages gained from its ability to pursue permissive policies in the past.

51. As Chile's financial problems mount, both the government and its opposition will be increasingly tempted to seek politically popular solutions, even though they may be economically short-sighted. The most tempting solution probably would be a grab for a larger share or all of the profits of the US copper companies or a default on foreign debt servicing payments. Even outright expropriation of the US copper companies probably would not benefit Chile's budget or balance of payments for very long, however. If arrangements for adequate compensation

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were made, the payments probably would largely offset the government's added revenues from the companies' profits (which are likely to decline under Chilean management). If adequate compensation were not offered, Chile would stand to lose more in US economic aid and inflows of private capital than it gained from sequestering the companies' total profits. In the somewhat less likely event that payments were withheld on the foreign debt -- about half of which is owed to the US government -- Chile's credit standing throughout the world would be damaged.

52. The US government's financial liability if the copper companies are expropriated could be sizable by 1970. Copper investments of between \$425 million and \$450 million that were made before the current expansion program are not insured under the Specific Risk Investment Guaranty Act. But the US government may have a liability of as much as \$400 million by the end of 1970, if the expansion program proceeds as scheduled. These insured investments probably will be carried out, since the US companies have nothing to lose by doing so. The Chilean Congress might try to nationalize the copper properties before Frei's term ends, in November 1970. It seems unlikely, however, that Frei would approve a congressional expropriation measure, though he might try to secure a much larger share of the companies' profits for Chile. A confrontation between Frei and the Congress on this issue could bring a political crisis, with unpredictable consequences.

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