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Chile's Growing Bind: Financial Solvency Versus Political Stability

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An Intelligence Assessment

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ALA 85-10125
December 1985

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Chile's Growing Bind: Financial Solvency Versus Political Stability [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis. It was coordinated with the Directorate of Operations. [redacted]

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Comments and queries are welcome and may be directed to the Chief, South America Division, ALA, [redacted]

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Key Judgments

Information available as of 1 November 1985 was used in this report.

During the past three years, Chilean President Pinochet has alternated between two economic policy options as he has sought to reconcile domestic demands for economic recovery and political liberalization with foreign creditor pressures for austerity and debt repayment. In early 1984, as the US Embassy reported, his greater concern over domestic protests led him to appoint a new economic team favoring expansionist policies that stimulated a "miniboom" and helped slow the momentum of the opposition movement. By early this year, in our judgment, he concluded that these policies and the state of siege imposed in November 1984 had succeeded in putting his political opponents on the defensive. This and his nervousness that reduced foreign lending was risking a payments crisis led to an about-face in early 1985, when Pinochet appointed new economic advisers, implemented tighter austerity, and concluded an agreement with the IMF.

Now, in our view, Pinochet is again at a crossroads in his economic policy dilemma. Following a $750 million IMF accord, increased World Bank lending, and a Paris Club rescheduling last summer, foreign commercial bankers have syndicated a three-year $1.1 billion loan and have rescheduled $5.9 billion of 1985-87 maturing debt. The political protest movement, however, is regaining strength at the same time that this complex loan package is coming together, partly because of the tighter economic measures that have been introduced to gain creditor support, in our judgment.

In spite of the renewed financial backing, we and several private-sector forecasters believe that Chilean economic growth will remain at about 0 to 3 percent over the next year. We foresee cuts in government spending for 1986, a slight rise in unemployment, inflation on the order of 35 percent, a drop in real wages for the fifth consecutive year, and depressed domestic savings and investment. Moreover, we expect another $1.7 billion current account deficit in 1986. This raises the danger that a further slowdown in the world economy, higher interest rates, delays in loan disbursement, or resurgent capital flight could produce a foreign debt payments crisis with little warning.

We believe this shaky financial position has potentially important political implications. Our past research has shown that in less developed countries political instability historically has been sparked more often by specific government economic policies—such as spending cutbacks, retraction of

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subsidies, wage restraints—that hurt large or influential groups than by general economic hardship as such. We believe this is primarily because such policies provide a rallying point for opposition political forces. We expect, that, in the case of Chile, the likelihood of more austere policies next year will again provide a focus for opposition activity. We judge that both moderate opposition forces and the radical left will attempt to exploit this public antipathy, and, as a result, Pinochet may face a significant rise in protest activity by mid-1986.

Even if Pinochet—whose manipulative skills are widely recognized—is able to avoid providing his opponents economically inspired opportunities, he is far from out of the woods. Recent economic studies by academic researchers, US econometric services, and the World Bank project continued external constraints on Chile's economic development over the next decade. [redacted] Pinochet is counting on 25X1 a future economic upturn to enable him to win uncontested reelection in the 1989 presidential plebiscite. Consequently, we foresee greater government intervention in the economy in the years ahead to promote development in hopes of serving Pinochet's political objectives.

There is little prospect that US interests will benefit from economically related problems in Chile. The regime could join Latin American proponents of a more politicized approach to regional debt if the financial squeeze tightens. Santiago's drive to increase exports threatens tougher competition for US producers at home and in third countries, as well as greater difficulty penetrating the Chilean market. In a worsening political conflict, moreover, Washington's goal of a peaceful transition to democracy in Chile will be caught between the partisan and increasingly polarized objectives of Pinochet and his opponents.

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Introduction

Until 1981, the Pinochet government's thoroughgoing, free market economic reforms generated a boom that helped avoid discontent over continuing tight political control and made Santiago a low risk for foreign creditors. However, a 14-percent contraction in the Chilean economy in 1982,[1] caused by world recession and the spillover of the Latin debt crisis, provoked several incidents of domestic unrest that year. This downturn, in our view, was the primary impetus for the political protest movement that began soon thereafter. According to the US Embassy [redacted] President Pinochet—concerned that opposition forces were capitalizing on economic hardship—ignored potential financial problems in 1984 and decided early in the year to stimulate the economy. [redacted]

The resulting "miniboom" mitigated economic distress, at least for the middle class, but, within a short period of time, created a major financial bind. Indeed, according to US Embassy and financial reporting, by late in the year, bankers became reluctant to supply Santiago with sufficient new money to support continued growth, which the regime believed was essential in order to deny its opponents the political initiative. Pinched by a shortage of investment funds and pushed to conserve foreign exchange, Pinochet now faces the same tough economic choices confronting most of Latin America's civilian leaders. The way he responds to the external pressures for debt repayment and the internal pressures for economic growth will not only determine the country's economic future, but may also affect the strength of the political protest movement and the government's international economic and political standing. [redacted]

[1] Unless otherwise noted, statistical citations are based on Chilean Government data. [redacted]

The Financial Turning Point

In early 1984, a declining standard of living and the lessons from a year of domestic unrest led Pinochet to adopt more growth-oriented policies in an effort to alleviate discontent. Democratic opposition forces called for reducing unemployment through increased state spending, according to press reports. Diplomatic reporting indicated that Chilean businesses were pressing for debt relief and faster economic growth. 25X1 Within the government, as well, pressure was building 25X1 for more expansionist measures. [redacted] [redacted] then Interior Minister Jarpa advised 25X1 Pinochet that growth-oriented policies were needed to reduce the popular grievances that were fueling political protests. 25X1 [redacted] after a large antiregime demonstration in March 1984, 25X1 Pinochet finally decided to heed this advice and replace his strict free market advisers with a team 25X1 favoring state-directed economic expansionism. [redacted]

In its first public address, the new economic team— 25X1 made up of Economy Minister Collados and Finance Minister Escobar—pledged to increase public spending and state enterprise investment to spur a strong economic recovery. Collados immediately increased outlays for housing, mining, and infrastructure improvements to reduce unemployment, according to press reporting. In May, financial statistics showed that the economic team eased domestic credit by injecting liquidity into a banking sector crippled by bad debts. Moreover, the US Embassy reported that, throughout the summer, the government also provided new subsidies and higher domestic price supports to promote domestic manufacturing, agricultural production, and export growth. These fiscal stimulants sparked rapid recovery—averaging over 7 percent in 25X1 the second and third quarters of the year—according to Chilean Government statistics. [redacted] 25X1

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Chile's Free Market Experiment

According to a review of academic studies, the Chilean Government's direct role in managing the economy grew steadily between World War II and the election of President Allende in 1970. Various administrations used price, interest rates, credit, and wage controls to manage an economy dependent on copper and subject to wild fluctuations caused by changes in international metal prices. Strong copper markets—accounting for over 80 percent of export revenues during most of the postwar period, according to trade statistics—provided the state with tax revenue to fund domestic investment and to grant wage hikes. High import tariffs and quotas sheltered public and private corporations from international competition. To reduce the economy's vulnerability to declines in copper prices, the government promoted the growth of state corporations, which may have controlled as much as 39 percent of domestic production, according to academic research.

Allende attempted to consolidate this trend by completely socializing the economy in the early 1970s. His ambitious efforts to nationalize private industry—including the nation's copper mines, mainly owned by US companies—bankrupted the national treasury. External aid ebbed to a trickle, foreign investors fled, and access to Western credit dried up. Allende's economic team—short of funds—resorted to printing money, which boosted inflation to over 1,000 percent in 1973. With the economy internationally bankrupt and the country in political turmoil, the military seized control of the government in September 1973.

To cope with the economic chaos, Pinochet turned to a group of orthodox, free market economists—many groomed at the University of Chicago—then known as the "Chicago Boys." They revitalized private markets by eliminating controls on prices, interest rates, and foreign exchange. They slashed state subsidies, cut spending and borrowing, and sold most nationalized firms to private investors. They also dismantled barriers to foreign investment, reduced tariffs, and eliminated trade controls. Foreign lenders and investors rushed to Chile, igniting a boom in 1976 that lasted until 1981. The results were impressive—according to government statistics, economic growth increased at an annual rate of over 6 percent, as inflation fell from nearly 175 percent to under 10 percent. However, international financial data show that Chile's debt tripled to over $15 billion, pushing debt service to an unsustainable 92 percent of exports. 25X1

According to Embassy reporting, Chile's free market search for its international comparative advantage led to a surge in commodity production, while inefficient manufacturing industries languished. Production of agricultural staples and textiles nearly died in the face of more efficient foreign competition, while exports of fishmeal, lumber, and fruits rocketed. Copper as a percentage of exports fell from 80 percent to 47 percent by 1983. The policy, however, left Chile dependent on world market prices and foreign financing. 25X1

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The experiment went awry when Santiago allowed the peso to become overvalued in an apparent attempt to suppress inflation. This encouraged Chileans to borrow heavily overseas and to import cheap luxury goods. When the international debt crisis hit, financial flows to Chile ceased. According to financial observers at the time, bankers were surprised to find that Chilean firms, having squandered their loans through purchasing nonproductive corporations and ill-considered investments, were bankrupt. The net effect of the funding cutoff, coupled with a world recession, was the 14-percent plunge in GDP in 1982. 25X1

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Effects of Policy Shift

While it is not possible to document a clear cause and effect relationship, we believe the shift in economic policies was a factor in the reduced level of protest activity in the first half of 1984. The regime's apparent responsiveness to the plight of the populace—rather than any immediate results from the new measures—seemed to undercut the ability of opposition forces to mobilize popular participation in protest activity. Lack of support from labor and the middle class in particular thwarted efforts by Pinochet's opponents to stage a national strike. The government shrewdly tailored some relief measures, such as providing subsidies for refinancing middle-class, business, and trucker loans, while boosting investments by state corporations to generate work for union and unskilled labor, according to US Embassy reports. [redacted]

[redacted] however, the switch to growth-oriented policies raised foreign bankers' apprehensions in late 1984 about debt servicing prospects, as Chile's current account position deteriorated throughout the year. Central Bank data indicated that the growing economy helped spur imports, while low copper prices kept export revenue down. This shrank the trade surplus in the first half of 1984 to $390 million—far below Central Bank economic projections—and left Chile without a trade surplus in the second half. Instead of making appropriate economic adjustments, the US Embassy noted, Santiago resorted to heavy short-term borrowing; [redacted]

Santiago also began pressing its creditors for an additional $500 million in longer term loans by trading on its past reputation as a sound credit risk. Bankers not only turned down the request, but, according to the US Embassy, the bank advisory committee representing Chile's commercial lenders threatened in August to withhold nearly $200 million in promised loans. Moreover, a resurgence of protest activity in September contributed to stiffened creditor resolve against new lending, [redacted] When the government imposed a state of siege in November 1984, bankers threatened not to reschedule Chile's 1985-87 debt and to cut its future access to credit. [redacted]

Pinochet's Tough Adjustments

Over the following few months, we believe two factors led Pinochet to shift economic policy again:

- His concern that reduced foreign lending would provoke a payments crisis.
- His belief that stern political measures had put his opponents on the defensive, reducing their ability to exploit economic issues.

Thus, in February 1985, he installed a new economic team, including new Finance Minister Buchi, that promised a return to strict free market policies. The financial press reported that the government delayed cost-of-living increases for pensioners, froze salaries for public employees, cut overall government spending by 10 percent, and reduced its direct financial assistance to private banks. [redacted] 25X1

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To further bolster creditor confidence, Chile pushed to improve its international financial position. In February the government reached preliminary agreement with the IMF for a three-year, $750 million extended fund facility. After a major earthquake struck Santiago and the principal port at Valparaiso last March, the Fund announced it was raising the budget deficit target to permit public spending for reconstruction. Meanwhile, according to the US Embassy and press reporting, the economic team pushed a wide range of promotional measures and incentives which they hoped in time would spur export growth, thus earning additional foreign exchange to pay the debt.[2] In March and June, Chile devalued the peso, improving its export competitiveness, and press reports indicate that another devaluation is likely soon. [redacted] 25X1

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[2] According to Embassy [redacted] Santiago has promoted its minerals, lumber, fruit, and fish products in new markets by increasing export credit and staging promotions at trade fairs. Additionally, the government is considering new tax and investment incentives to encourage added processing that will raise export values. The US Embassy also reports that Santiago is proposing legislation to provide direct incentives to export industries—including a 10-percent export rebate scheme, increased export financing, and a new export insurance facility. Further, PROCHILE—the government export promotion agency—has been restructured to develop programs to help small producers penetrate overseas markets. [redacted]

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Figure 2. Structural damage due to earthquake. [redacted]

Bankers' Support Regained

The change in the economic team delayed the complex debt financing package for several months. [redacted] bankers were still nervous about lending to Chile, offering only $300 million in new money—a fraction of the $2 billion originally requested for 1985 financing needs. Meanwhile, the US Embassy reported that Chile's dwindling trade surplus—hurt by falling commodity prices—forced Financial Minister Buchi to draw down reserves to keep debt servicing current. [redacted]

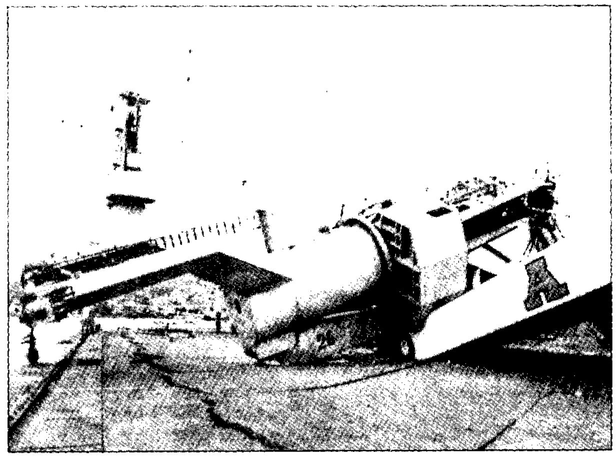

Figure 3. Damage to loading facilities at Valparaiso port. [redacted] 25X1

At this point, several factors led bankers to renew financial support for Santiago, [redacted] 25X1 On the economic side was Chile's worsening payments position and Pinochet's positive free market shifts. 25X1 On the political side was the President's decision last June to lift the state of siege, reflecting both international political pressures and, in our judgment, Pinochet's view that protest activity was containable. After Santiago relented in its opposition to multilateral development bank borrowing, the World Bank approved a $300 million cofinancing loan with private bankers and granted several project loans. Meanwhile, Chile's IMF program was cemented in July, setting the stage for a Paris Club agreement to reschedule $170 million of public debt. Commercial bankers began syndicating a three-year $1.1 billion loan, while rescheduling $5.9 billion of 1985-87 maturing debt. [redacted] 25X1

The Economic and Political Cost

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Santiago's moves to set the stage for new lending aggravated domestic economic stagnation, according to US Embassy reporting. Tight foreign exchange and the uncertain domestic climate have inhibited domestic investments. 25X1 Government statistics show economic growth neared zero in the second and third quarters of 1985, and unemployment oscillated around 14 percent. 25X1 Additionally, the government's cancellation of cost-of-living increases and other belt-tightening measures caused real wages to fall 8 percent by August 25X1 over the same period last year. [redacted]

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As in 1983, we believe this economic stagnation is again causing general domestic dissatisfaction and greater middle-class support for an accelerated transition to civilian rule. Pinochet's cutbacks in social spending and financial relief programs, the eroding living standards, and an uncertain business environment have left the government vulnerable to opposition forces. In August, the leaders of the democratic opposition finally hit upon a device for channeling growing middle-class frustrations over economic hardship and political deprivation—the so-called National Accord. This platform, agreed to by 11 opposition groups ranging from center right to center left, is the first broadly supported formula for transition to civilian rule that also has some appeal for moderates within the government.[3] [redacted]

Public opinion polls, US Embassy reporting, [redacted] make clear that dissatisfaction also is growing among the lower classes, especially in the slum neighborhoods surrounding Santiago and other major cities. The Communist Party has doubled its membership by recruiting large numbers of unemployed workers and students, according to the US Embassy. Until recently, organized labor—divided by Pinochet's efforts to depoliticize and downgrade union influence—has not been responsive to Communist appeals for a general strike. Nevertheless, we believe the mood among the rank and file may be shifting as union members have taken a more active role in the latest protest activity. [redacted]

The Knife's Edge

We believe this three-year process of economic and political pushing and pulling has left the competing forces in Chile, as well as interested international players, each at its own crossroads. The government is again confronted with the challenge of formulating economic policies that will deprive its opponents of exploitable economic issues without forfeiting its international creditworthiness. The opposition political forces potentially have another opportunity to rally popular opinion and put the regime further on the defensive. International creditors are calculating how much more money to risk in hopes of recovering existing loans. Interested foreign observers are concerned about finding a way to encourage responsible political forces in Chile to work out their own peaceful transition to democracy. [redacted] 25X1

[redacted]

The US Embassy reports that the regime, for its part, now intends to assuage rising discontent over the economy by expanding the domestic money supply—a move reminiscent of state-directed growth policies in 1984. We believe that this option is preferred because by July, according to US Embassy reporting, Santiago already was bumping up against the public-sector 25X1 fiscal deficit target set with the IMF for 1985, leaving little room for increased government spending in the 25X1 second half. Based on Chile's recent experience, we believe increased monetary expansion will produce an 25X1 initial spurt of growth and inflation, increasing import demand. Unless Santiago receives waivers from the IMF on its monetary targets, however, we judge it will remain vulnerable to a suspension of multilateral and commercial loan disbursements at the same time its foreign financing requirements begin rising. [redacted]

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Although negotiations with foreign banks have been concluded and loan disbursements are to begin around 25X1 the turn of the year, [redacted] Chile will not receive the full complement of 25X1 funds right away. As it is, we estimate the current account deficit will reach $1.8 billion for 1985. To meet this gap, Santiago has drawn down reserves to 25X1 remain current on its payments until bank funds are made available. Because of this, Chile is near financial insolvency, having already drawn down over 80 percent of its $1 billion net foreign exchange reserve cushion, according to US Embassy reporting. Foreign exchange reserves also have been eroded, according to press reports, by a decline in the repatriation of profits by Chilean firms and by increased capital flight 25X1 stemming from growing nervousness over the political situation. [redacted] 25X1

The Impact of the National Accord on Chile's Political Situation

The Accord. *In late August, 11 leading parties, acting in concert with Cardinal Fresno, composed their main differences and formulated moderate proposals to the government for a transition to civilian rule. They overcame the major sticking point—whether to endorse Communist participation in the political process—by proposing all totalitarian parties be banned by court action. Numerous other parties and special interest groups have since endorsed the accord.* [redacted]

Pinochet rejected the accord and insists on sticking to the drawn-out timetable for a transition to civilian rule contained in the 1980 Constitution. In a major speech in mid-September, he accused the accord's proponents of wanting only to gain power and of being soft on Communism. [redacted]

Pinochet, nevertheless, is concerned, [redacted]

The US Embassy believes that some Army generals will accept modifications of the 1980 Constitution and that sentiment may be growing for the military's abdication of power once responsible civilians are ready to assume it. Key civilians in the government reportedly also favor a more accommodating stance. [redacted] 25X1

The Moderates' Strategy. *The Embassy notes that the alliance among the moderates is fragile and that it may yet collapse over interpretation of key provisions. At this point, however, the moderates appear united in their readiness to be flexible; they have publicly stated that virtually everything in the accord is negotiable. They seem especially anxious to avoid supporting antiregime violence because this would leave them open to charges of collaborating with the Communists and give the government a pretext for ignoring the accord.* [redacted]

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Moderate leaders nevertheless believe that concrete measures, such as legalization of political parties, are needed to avoid greater political radicalization of the country, according to press [redacted] *To demonstrate that the accord enjoys broad national support, the parties are pressing ahead with a petition-signing campaign that concentrates on the middle class. They are counting on Cardinal Fresno's continuing involvement and are probably heartened*

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Near-Term Outlook

We concur with several estimates by private-sector forecasters that Chilean economic growth will remain low—about 0 to 3 percent—over the next year and probably beyond. In our judgment, cuts in government spending will boost unemployment slightly above 14 percent, while real wages will probably drop in 1986 for the fifth year in a row as labor settlements fail to keep pace with Chile's high inflation. Despite a tightening of fiscal policy, the momentum of price increases, coupled with more rapid money supply growth, is likely to push inflation up to about 35 percent. World Bank assessments contend that Chile cannot return to robust growth without increasing domestic savings. These have tended to dry up during periods of high inflation because of Santiago's unwillingness to maintain sufficiently high real interest rates, leaving most banks with a dearth of investment funds and heightening the risk of business failures. [redacted] 25X1

Based on US Embassy reporting and on assessments by US econometric forecasting services, we project Chile—assuming no pickup in domestic unrest—is again headed for a $1.7 billion current account deficit in 1986, principally because of depressed commodity export prices. A slowdown in the world economy, a spurt in imports, higher interest rates, delays in loan

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[redacted] that he will resume an active role as mediator once the signature campaign gains momentum. [redacted]

The Communists' Position. *The Communists underscored their strength in urban slums by organizing widespread violent demonstrations in September and by conducting another demonstration in early November. Party leaders appear to be weighing the risks of proceeding without cooperation from the moderates, while the regime is determined to crack down on protests. Meanwhile, the US Embassy reports that the bombings that blacked out most of the country in both September and November demonstrate the increased capabilities of leftist terrorists. [redacted]*

Outlook. *Because Pinochet probably realizes that his backing within the government and the military is uncertain and that resuming a state of siege could hurt Chile's economy by reducing access to new loans from international financial institutions, he is likely to temper his actions somewhat. Nevertheless, if terrorism escalates, he may reimpose the state of siege, calculating that he can point to growing Communist-led violence, rally armed forces support, undercut the national accord, and ignore international criticism. [redacted]*

[redacted]

What the National Accord Proposes: 25X1

- *An immediate end to restrictions on civil liberties.*
- *Direct presidential and congressional elections, with no date specified.*
- *Permitting future amendments to the 1980 Constitution, which is nevertheless implicitly endorsed.*
- *No witch hunt against members of the armed forces after they return to the barracks.*
- *Banning "totalitarian" parties—implicitly the Communist Party—by later court action.* 25X1
- *Avoidance of violence by its signatories.*

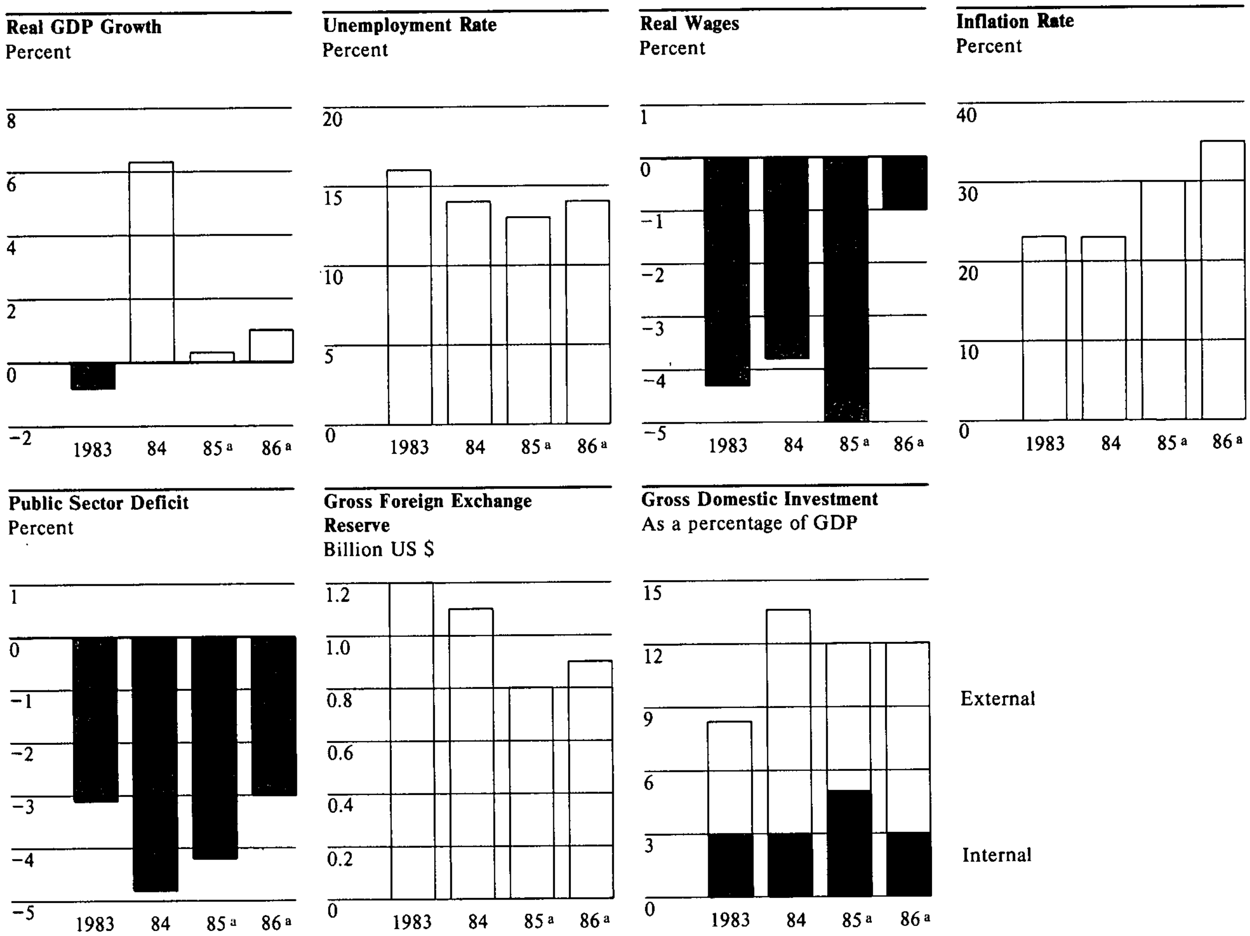
It does not call for President Pinochet to step down before his term ends in 1989. [redacted] 25X1

disbursement, or resurgent capital flight would precipitate an acute foreign exchange crisis, in our view, probably causing Santiago to suspend its interest payments temporarily. [redacted]

If the experience of the past few years is a guide, the linkage between political unrest and investor/lender nervousness suggests that local discontent increases the risk of Santiago's payments position quickly deteriorating. According to projections made by Chile's bank advisory committee, funding from the IMF, World Bank, and commercial creditors is in rough balance with foreign financing requirements through 1986. If capital flight again picks up, we believe the government would resort to restrictions on foreign exchange operations and the freezing of dollar accounts, probably causing bankers to suspend credit—as they did in January 1983—which would in turn bring about contraction of the economy. [redacted] 25X1

The prospects of such a financial crunch, in our opinion, would force Santiago to again tighten the fiscal policy as well as increase restrictions on the money supply. We would anticipate additional cuts in social spending, and we believe state corporations would reduce their employment-creating investments to shore up earnings that make up a major share of government revenues. Earthquake reconstruction efforts and other infrastructure-oriented projects would 25X1

Figure 4
Chile: Selected Economic Indicators, 1983-86



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also probably be postponed to hold down import requirements. According to press reporting, Pinochet has even suggested that military spending might be reduced, although this already is comparatively low, and we judge that further cuts are unlikely.[4]

Under these kinds of pressures, we believe the government would again approach creditors for additional lending. Based on current reports of continuing banker nervousness over Chile, however, we doubt Santiago would find much help. This could lead Pinochet's spokesmen to request debt relief from the

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Financial Bind Hampers Reconstruction Effort

The March 1985 earthquake—that left $1.8 billion in damages—has placed additional demands on Chile's economy, according to US Embassy reporting. Although Santiago received IMF approval to increase domestic deficit spending from 3 to 3.5 percent of GDP, this provides only $90 million for relief. The government freed another $150 million by delaying pension and employee cost-of-living increases until next year. Santiago's use of reserves to pay its debt and its declining trade surplus also have limited imports of goods necessary for reconstruction. Additionally, Chilean policymakers are torn between directing investment funds to reconstruction or to the export industries. Ignoring reconstruction could aggravate domestic unrest, while failure to increase export-oriented investment would reduce economic growth and worsen the current account deficit over the next several years.

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bank advisory committee in forms such as capping interest payments, resulting in negotiations that would be watched closely by all Latin American debtors.

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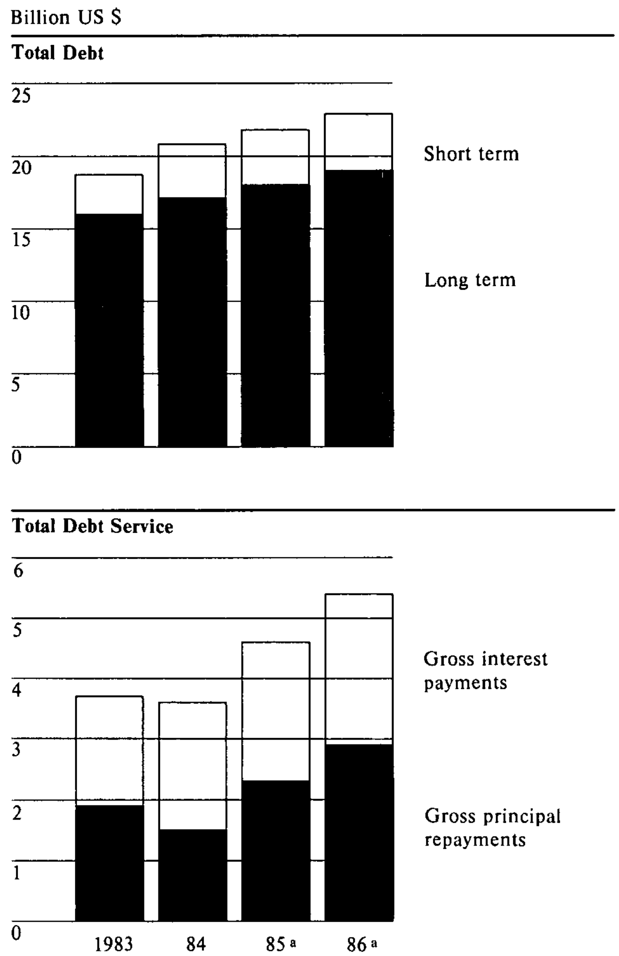
Political Repercussions

In some respects, Chile fits the pattern described in past CIA research [5] on the relationship between economic problems and political instability. This research noted that specific government economic measures—spending cutbacks, the retraction of subsidies, wage restraints—that hurt large or influential segments of the population are more likely to provoke instability than general economic hardship shaped by the country as a whole. The primary reason seems to be that such policies provide a rallying point for opposition forces. As noted earlier, there have been instances in Chile since 1983 when tough government-imposed austerity measures clearly helped catalyze protests. Moreover, in early 1984, when the government—in apparent recognition of the phenomenon—granted additional relief for miners and other key groups, support for the protest movement waned.

Figure 5
Chile: Debt and the Servicing Burden, 1983-86



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Thus, we believe that the continuing financial bind, the likelihood of tighter government economic policies next year, and eroding living standards will lead to increased discontent among a wide variety of groups. Based on US Embassy reporting, we see an increasing

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Table 1
Chile: Balance of Payments

Billion US $

	1983	1984	1985	1986
Current account balance	−1.1	−2.0	−1.8	−1.7
Trade balance	1.0	0.3	0.5	0.5
Exports	3.8	3.7	3.8	4.0
Imports	−2.8	−3.4	−3.3	−3.5
Net services and transfers	−2.1	−2.3	−2.3	−2.3
Net interest	−1.7	−2.0	−1.9	−2.0
Net other	−0.4	−0.3	−0.4	−0.3
Capital account	0.4	2.0	1.6	1.8
Long-term inflows	1.1	1.0	1.3	1.7
Principal repayments	−0.9	−1.7	−2.0	−2.1
New borrowing	2.0	2.7	3.3	3.8
Short-term debt	−0.8	1.0	0.2	0.0
Direct investment	0.1	0.1	0.1	0.0
Change in reserves	0.6	0.1	0.3	−0.1

Note: Numbers do not exactly balance due to rounding of raw data.

pool of individuals who could be brought to rally against unpopular government policy moves:

- There are increasing numbers of urban poor and unemployed youth who are potential recruits for radical leftist parties and terrorist groups.
- Among the middle class there is increasing disenchantment with economic policies that depress income and employment prospects and limit credit availability.
- As far as Chilean youth are concerned, as employment prospects for university students are becoming bleaker, more of them are becoming radicalized.

In our judgment, over the next year, there will be a sustained effort by both moderate opposition groups and the radical left to exploit any government missteps and capitalize on economically spawned social discontent. Democratic political forces are more likely to seek middle-class support for peaceful social mobilization activity, while the far left probably will engage in more frequent terrorism. In the absence of steady economic growth or government concessions, by late 1986 Pinochet may face a significant rise in protest activity, assuming opposition forces continue to present a relatively united front against the regime.

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An Alternative Scenario

We believe there is a slight chance that President Pinochet—whose manipulative skills are widely recognized by observers of the Chilean scene—could take steps to deprive his opponents of the opportunity to use the economic lever against him. Instead of replenishing foreign exchange reserves, as called for in its IMF program, Chile could direct loan disbursements toward new job-creating investments of $500-800 million and press official and commercial creditors for more lending. This would require waivers from the IMF on performance targets to avert a suspension of loan disbursements. 25X1

Pinochet could also use new funds, at least in the short term, to ease discontent by injecting new spending on a wide front:

- Direct debt relief for middle-class mortgagers and small businesses. 25X1
- Cost-of-living increases for government workers and wage hikes for nonpublic workers.
- Expanded public works and social help programs.
- Increased construction projects by government corporations to reduce unemployment.
- Financial relief and government shipping contracts for truckers.
- Subsidies and import protection for domestic manufacturers.
- Expanded agricultural price supports. 25X1

Most of these "social subsidies" would be unsustainable into 1987, in our judgment, without strong and continuing international support or a dramatic strengthening of commodity prices. As far as international lenders are concerned, we doubt they would be willing to see funding diverted into social programs that would only end up increasing Chile's financial needs. 25X1

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Table 2
Comparison of Projections for Leading Economic Indicators

	CIA		Data Resources, Inc.		Wharton Econometric Forecasting Inc.		Chase Econometrics		Central Bank of Chile	
	1985	1986	1985	1986	1985	1986	1985	1986	1985	1986
Real GDP growth	0.0	1.0	1.5	3.3	2.2	0.2	2.3	3.5	4.0	5.0
Unemployment	13.0	14.0	16.1	14.9	14.0	13.3	NA	NA	13.0	NA
Inflation	30.0	35.0	26.5	25.9	29.8	16.5	30.0	20.2	25.0	NA
Gross domestic investment *(as percent of GDP)*	12.0	12.0	13.6	14.5	13.7	13.4	13.1	13.2	13.1	14.7
Current account deficit	−1.8	−1.7	−1.8	−2.2	−1.3	−0.8	−1.5	−1.3	−1.4	−1.3
Trade balance	0.5	0.5	0.5	1.1	0.9	1.2	0.6	0.8	1.0	1.3

[redacted] 25X1

Indicators that Pinochet was seriously thinking about the "social subsidies" option would include:

- Replacement of free market members of the economic team with more state-oriented advisers.
- An expanded policy formulation role for the Social and Economic Council.
- Increased Chilean backing for initiatives by the Cartagena Group of Latin debtors.
- Government proposals for new import regulations to protect industries such as textiles. [redacted]

Longer Term Economic Prospects

Even if Pinochet is able to neutralize the economy as an issue next year, he is far from out of the woods. Recent economic studies by academic researchers, US econometric services, and the World Bank indicate that external constraints will continue to impede Chile's economic development for the rest of the decade. Despite the rescheduling of 1985-87 debt, these sources project that Santiago will have difficulty meeting its debt service burden because of heavy dependence on copper exports. [redacted] 25X1

[redacted] Pinochet is counting on a future economic upturn to enable him to win uncontested reelection in the 1989 presidential plebiscite. Consequently, we believe the odds of Pinochet's becoming disillusioned with his current economic stabilization policies and turning to state-directed growth to serve his political objectives will only increase over time. [redacted] 25X1

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If Pinochet marches down this path, we believe the state will take a heavy future role in this restructuring of the economy and in directing credit into areas that could fuel domestic expansion. Press reports indicate that Chilean businessmen are already calling on the government to develop an economic strategy heavily oriented toward import substitution and export promotion. Santiago is likely to make sure that the investment projects it targets receive ample domestic credit and preferential treatment in obtaining government contracts and foreign exchange. At the same time, we would expect to see some elements of a "social subsidies" approach: agricultural price supports, which would reduce dependence on imports; and increased trade barriers, which would spur

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Chile's Increased Dependence on Multilateral Lending

Faced with commercial banker resistance to increased lending to support economic growth, the US Embassy reports that the Chilean economic team is reversing a decade-old policy and seeking major loans from multilateral and bilateral financial institutions. This policy reversal did not come easily, [redacted] *because cutoffs in funds from the development banks helped destabilize the Allende government—a lesson not lost on Pinochet. Nonetheless, Santiago acquiesced this year after bankers insisted it apply for multilateral development bank credits as a precondition to earnest financial negotiations.* [redacted]

Chile is asking the World Bank for over $350 million in 1985—$250 million in the form of a structural adjustment loan—plus guarantees for a $300 million loan cofinanced with commercial bankers. Additionally, Santiago will seek a $250 million structural adjustment loan in 1986 and, according to US Embassy reporting, over $100 million in various project credits. The Inter-American Development Bank will lend Chile over $500 million in 1985-86. [redacted]

We also foresee Santiago requesting more US AID funds to address growing economic problems. Chile's increased emphasis on agriculture and road development, set against strained domestic resources, provides the impetus. Further, Santiago will probably seek expanded CCC credits, but use these funds for the purchase of other commodities as Chile becomes self-sufficient in grain. Taken together, we estimate multilateral and bilateral sources could lend Chile over $2 billion in the next three-year period—twice as much as new bank lending—thereby heightening Pinochet's dependence on these sources and, consequently, his vulnerability to associated international political pressures. [redacted]

growth of domestically produced goods. In addition, the government would probably push incentives for export-oriented industries, which are the key to meeting future debt servicing requirements. [redacted] 25X1

We believe that the end result of growing state intervention and more nationalistic policies will be a substantially transformed economy. The move away from free market policies to the use of wider ranging controls and increased expenditures to guide and subsidize development will once again, in our view, lead to stagflation, similar to Chile's economic performance between 1930 and 1973. Despite government efforts to promote exports, Chile's balance of payments will remain in disequilibrium and vulnerable to external shocks that would precipitate periodic payments crises. [redacted]

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Implications for the United States 25X1

There is little prospect that US interests will benefit from economically related problems in Chile. In view of Santiago's continuing economic troubles, which have occurred despite its willingness to work with the IMF, Chile could be cited by other debtors as an example of the failure of the post-1982 approach to debt problems. As far as Chile is concerned, we expect that, given the political situation, the government will press for more flexibility in resolving its financial dilemma. This could include more political activism, ranging from direct appeals for US Government backing with commercial lenders to more active collaboration with other debtors in the Cartagena Group. We believe the Pinochet government will broach a cap on interest payments or other forms of debt relief in the event bankers refuse new loans. Other Latin debtors could be encouraged to follow suit, pushing debt rescue programs in new and uncharted directions. [redacted]

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Chile's pressing need to increase exports will probably result in growing bilateral frictions. We believe Santiago will look to its traditional export markets—such as the United States—in the next three years to absorb its increased production of copper and fruit, posing tougher competition for US producers at home and in third-country markets. Additionally, Chile is eyeing the potential for its arms industries to earn foreign exchange through increased exports. Growing exports by countries like Chile, Argentina, Brazil, and other Third World providers will help countries, such as Iran and Iraq, which offer tempting arms markets.[6] Moreover, the pressure to sell could easily play into the hands of gray arms market purchasers who are willing to pay up front in hard currency.

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The shift away from strict market-oriented policies also would damage US commercial interests. Multinational corporations will remain vulnerable to tougher regulations on their foreign exchange transactions and investment projects. At the same time, higher tariffs and import controls will limit the ability of US exporters to make competitive gains in the Chilean market.

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Finally, a worsening political conflict in Chile would affect US interest in seeing a peaceful transition to a democratic government. Moderate opposition forces would expect the United States, in our view, to press the regime to adopt an accelerated transition timetable. Pinochet, on the other hand, would seek US economic support, but he would not necessarily agree, in exchange, to hasten the return to civilian rule.

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