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Chile: Embarking on Trade-Led Economic Expansion

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A Research Paper

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ALA 86-10039
September 1986
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Chile: Embarking on Trade-Led Economic Expansion

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A Research Paper

This paper was prepared by 25X1
Office of African and Latin American Analysis. It was coordinated with the Directorate of Operations. 25X1

Comments and queries are welcome and may be directed to the Chief, South America Division, ALA, 25X1

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Chile: Embarking on Trade-Led Economic Expansion

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Summary

Information available as of 1 August 1986 was used in this report.

Chile has developed a trade promotion program that, in our view, has promising prospects to spur economic growth and earn foreign exchange to service Santiago's debts. The program is realistic, well thought out, and comprehensive in scope. It is also being competently implemented by one of the most skillful and least corrupt bureaucracies in South America. Moreover, while the plan makes ample use of government subsidies and production incentives, it has avoided a rigidly statist or nationalistic approach that would stifle private-sector initiative and work against foreign participation.

The program focuses on expanding Chile's present line of exports. Santiago plans to:

- Boost copper output at state-owned mines, provide incentives for private interests to open new mines, and improve sales to Europe and Asia.
- Develop lumber exports by working with the private sector to improve forestry techniques and develop infrastructure, and by cultivating the Chinese and South American markets.
- Expand fruit production and either process or cold store some of the increase for delayed shipment to the US market and Pacific Rim countries.
- Shift fishing toward more lucrative edible fish and improve marketing in Europe, the United States, and the Pacific Rim.
- Increase arms sales by licensing and adapting foreign-produced weapons for domestic use and marketing the mature product to other *Third World countries.*

Despite its many promising aspects, we doubt Chile's program will achieve its objective of generating a 13-percent annual rate of growth in export revenues. Meeting this goal depends on an ambitious investment program. The government will have to resist pressure from big business to keep interest rates low—already there is some evidence of backsliding—in order to generate savings necessary to spur capital investment in the export sector. Santiago also needs to maintain current foreign investment flows—$112 million in 1985—which will require good relations with international financial institutions and a modicum of political stability. Although Chile continues to diversify exports to reduce the vulnerability of its export earnings to copper price fluctuations, the program still depends on 7-percent annual growth in copper prices—which we think is unlikely.

ALA 86-10039
September 1986

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Nevertheless, we believe that the momentum generated in the export program to date—coupled with modest levels of domestic investment and stabilizing commodity prices—should be sufficient, in the absence of adverse political developments, to allow growth in the export sector to average a robust 7 percent a year through 1989. Under these circumstances, Santiago will continue to require commercial bank lending into the 1990s but probably at a level that will avoid serious confrontations with creditors.

The export sector probably will help the Chilean economy expand by an average annual rate of 2 to 4 percent, but this will not alleviate President Pinochet's political headaches. Export-led growth will not significantly reduce unemployment in the manufacturing sector in the urban shantytowns—important centers of anti-Pinochet activity. We believe that only a highly unlikely economic boom—with overall annual growth rates of 6 percent—would significantly boost Pinochet's popular support and reduce agitation for a speedy return to democratic rule.

Although Chile's exports would falter if commodity prices plunged, we see a greater threat to the program from competing policy goals within Chile itself. Pinochet could be tempted to curry domestic favor prior to the presidential plebiscite slated for 1989 by adopting quick-growth policies that emphasize consumption over savings, thereby crippling Chile's investment rate and hamstringing the export expansion program. Also, the refusal by the regime to liberalize or reduce human rights violations has already caused creditor countries to consider voting against or delaying multilateral bank loans to Chile—developments that would jeopardize Santiago's access to commercial credit. The export program, in our view, could be severely damaged if external funds were delayed for as little as six months.

We anticipate that Chile's promising export promotion program will have a mixed impact on US interests. In our view, the marginal GDP growth likely to be generated by the program will not significantly improve President Pinochet's political standing or otherwise weaken forces encouraging a transition to civilian rule. Export growth will help US banks—which own half of Chile's commercial debt—by reducing Santiago's need

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for new loans and debt reschedulings. A jump in Chilean copper production, however, could blunt the recovery of world prices, making the reopening of US mines unprofitable. Chilean fruit producers could clash with US growers if they begin to export to the United States during the regular US selling season. Moreover, we believe Santiago will continue to ignore US objections to its arms sales to countries such as Iran because of its need for foreign exchange and its already contentious relations with Washington.

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[redacted]

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Contents

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Figure 1

Boundary representation is not necessarily authoritative.

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Chile: Embarking on Trade-Led Economic Expansion [redacted]

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Introduction

When Chile's economy crashed in 1982, commercial bankers pressed Santiago to impose austerity measures to rectify its external accounts and reduce new loan requests. Since then, Santiago has searched for a solution to its balance-of-payments disequilibrium that would enable it to maintain economic growth while still servicing its foreign debt. Chile balanced its external accounts in 1982 and 1983 at the cost of a 16-percent slide in GDP and an unemployment rate of more than 30 percent. [redacted]

In 1984, President Pinochet responded to rising political unrest—which [redacted] he ascribed to the languishing economy—by stimulating economic growth through looser fiscal and monetary policies and a sharp increase in short-term financing. Although these moves raised GDP by more than 6 percent and created jobs, commercial creditors—worried that the buildup of short-term loans might precipitate a financial crisis—threatened to deny future financial relief unless the government returned to tighter policies. Pinochet responded in 1985 by adopting a trade expansion program that he hoped would help Chile meet creditor demands without sacrifices that would aggravate political discontent. This paper reviews Santiago's export plans and related economic policies; projects likely prospects for Chile's major export products over the next several years; and assesses the impact on Chile's balance-of-payments situation, political stability, and US economic interests. [redacted]

International Financial Support for Chile's Export Program

Chile concluded a three-year foreign financing package last year to support an export expansion program designed to encourage economic growth and provide foreign exchange to service its debt. The main features of this program include:

- *An IMF Extended Fund Facility providing $750 million over three years for balance-of-payments support. Repayment, however, of past IMF drawings will reduce the net benefit of these funds.* 25X1 25X1
- *A World Bank structural adjustment lending program that provides for three consecutive loan years of $250 million each with disbursement each year contingent on successful completion of the previous year's program and formal approval by the executive board for the next year's loan.*
- *A World Bank cofinanced loan of $300 million with commercial banks.*
- *A collection of project loans from the World Bank and the Inter-American Development Bank—some already approved and others yet to be requested—to cover Chile's remaining financial gaps.*
- *A commercial bank rescheduling of more than $6 billion in 1985-87 loan maturities and $700 million in loans to be disbursed in 1985 and 1986.* 25X1
[redacted] 25X1

The Export Expansion Program

Basic Strategy

While Chile is encouraging import substitution and increased efficiency through the privatization of state industries, the main thrust of Santiago's effort to stimulate the economy is its export expansion program. In our view, Santiago's budgetary constraints will force the government to concentrate in the short run on expanding the volume of the country's present exports, which, though still dominated by metals and minerals, increasingly consist of wood products, fruits and vegetables, fish, and arms. Additionally, the government wants to increase export value by helping producers process their commodities in-country and spurring demand for these goods by actively promoting them abroad. Santiago has stated that it hopes Chilean entrepreneurs will respond over the longer run to its new export subsidies and services by developing new export goods and markets.

Metal and Mineral Development

Copper. Although a rapid rise in nonmining exports over the last decade has decreased the relative weight of copper as a percentage of overall Chilean exports—from 58 percent in 1976 to 48 percent last year—Santiago has, in fact, increased production. The US Embassy reports that Chile is making progress toward the goal it set in 1983 of doubling copper exports by 1994. The high grade of its ore and efficient production techniques have permitted Chile to take advantage of low world copper prices to drive out competitors and grab a larger market share. Over the next several years, we expect CODELCO—Chile's state copper company—to lead the expansion by using multilateral bank loans and retained earnings to enlarge and modernize its present facilities. Chile's copper production infrastructure is already so well developed, and its natural endowment so extensive, that we believe CODELCO will be able to substantially boost output during the remainder of the decade.

Chilean trade officials appear to hope that falling world inventories and lower interest rates will spur demand and raise prices. Nevertheless, over the past several years, Chile's own expansion of copper exports, the rise of copper substitutes, and surplus production capacity elsewhere have suppressed world market prices and kept Chilean copper revenues stagnant. Even if prices remain depressed, however, and Chile's other ambitious copper-related projects do not bear fruit, we believe Santiago will press on toward meeting its production goals.

Determinants of Copper Demand

Copper accounts for nearly 50 percent of Chile's export revenues. Although Chilean copper production continues to rise, revenues over the past few years have lagged. Several forces have slowed the growth in world copper demand:

- ***Exchange rates.*** *A strong dollar has hurt Chilean copper sales to Europe. World copper prices are set in dollars, which means that, although copper prices in recent years have been near historical lows in dollar terms, they were prohibitively high in terms of English pounds and German marks. Furthermore, Chile has tried to reduce copper exports to the US market—where it has its best competitive price—to avoid provoking US trade retaliation. Nevertheless, if the dollar continues to weaken against European currencies, Santiago's sales to Europe could recover quickly.*

- ***Interest rates.*** *High interest rates have suppressed the demand for copper by discouraging housing starts and raising the cost of holding inventories. Although interest rates have begun to decline, we doubt that this will rapidly translate into increased demand. Copper manufacturers have learned tighter inventory management techniques that they are not likely to abandon. Also, the recent price volatility of the copper market has made buyers wary of purchasing in advance of their needs and of being suddenly caught with a large inventory of high-priced copper.*

- ***Substitutes.*** *Other materials are now competing with mined copper in several markets. Fiber optics, for example, are beginning to replace copper in telecommunications networks, and housebuilders are shifting to cheaper plastic water piping. In addition, recycling of old copper wire and other scrap copper has further reduced the demand for newly mined copper.*

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Santiago is trying to lure foreign investors into opening new mines through new incentives and reforms in the mining laws, according to US Embassy reports. The government has also offered to share foreign investor risk by forming joint ventures, but even this has failed to elicit much response, according to the US Embassy. Some potential backers probably fear that a post-Pinochet government would change the investment laws, while other investors—such as Finland, which recently pulled out of a major copper mining project—are withdrawing to protest Pinochet's political inflexibility and his government's human rights violations. Still others are delaying new investment until international copper prices start showing signs of a rebound, according to Chilean trade journals. Foreign net direct investment has dropped so low that the total for the last four years will probably be less than it was in 1982 alone.

Santiago is responding to US pressures to restrict copper imports by redirecting sales to other parts of the world. Chile started reducing copper sales to the United States in 1983; fresh fruit has now replaced copper as the country's main export to the United States. Santiago plans to expand its copper sales in Europe and Japan, and to further develop its promising new markets in South Korea and China, according to press reports.

The press also reports that the government hopes to increase earnings by exporting manufactured copper products, but CODELCO does not appear to be positioned for such a development. The US Embassy reports that CODELCO may be selling copper to domestic manufacturers at prices that exceed its foreign sales price. This practice, if true, places domestic manufacturing of copper tubing and wire at a competitive disadvantage in world markets. The US Embassy notes that CODELCO already owns several manufacturing plants in Europe, is discussing a joint production plant with China, and may not be interested in helping potential domestic competitors.

Other Metals and Gas. We believe that government promotion of molybdenum and lithium could make Chile a major producer in these markets. The volume of exportable molybdenum—a byproduct from the processing of high-grade copper ore—will rise naturally with copper production. Chile already has become the third-largest exporter of this metal in the world—behind the United States and Canada—with annual sales of roughly $100 million. An erratic market for molybdenum, however—such as has prevailed over the past few years—may prevent the metal from becoming a major export earner. 25X1

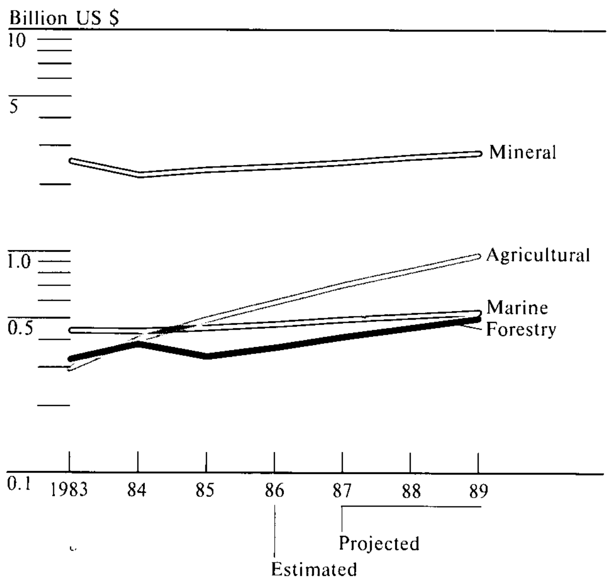
Chile has only recently begun developing lithium—it holds an estimated 40 percent of the world's reserves—through a joint project between Chile's state development corporation and Foote Mineral Corporation, a US firm. The press reports that the group plans to market in Canada, Europe, the United States, Argentina, and Japan. Although the project could capture as much as 15 percent of the world market within a few years, this is not likely to produce a 25X1 windfall for the government; we expect the new production, added to an already growing surplus market, will merely flatten world prices. 25X1

Natural-gas-related projects could be more of a boon to Chile. Santiago is currently developing two projects to produce methanol products for export. ENAP—Chile's national petroleum company—and Combustion—a US concern—plan to construct jointly a plant capable of producing 1,700 tons of urea and 350 tons 25X1 of ammonia. In addition, Signal Methanol company, the International Finance Corporation, and two Chilean firms expect to complete construction next year on a methanol plant. Press reporting suggests that the Signal project alone could generate $6 billion over a 20-year period; ENAP will most likely receive $1.8 billion of these revenues, with the government garnering another $875 million in taxes. Methanol is used as a gasoline additive and in the manufacture of products ranging from wood adhesives to plastics.

Expanding Chile's Other Major Exports 25X1

Over the last decade, Chile has diversified its export base by invigorating the forestry, fish, and fruit and 25X1 vegetable sectors. While past investments are now beginning to pay off in strong production, generally

Figure 2
Chile: Exports by Product Group, 1983-89



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low commodity prices have suppressed earnings. Even so, Santiago appears to be gambling on improved markets, using World Bank and Inter-American Development Bank loans to support continued growth. Nevertheless, we believe that strong export growth into the 1990s—particularly for wood products and fish—will depend heavily on sharp increases in both domestic and foreign investment.

Agriculture. Agricultural exports, led by grapes and apples, have expanded fourfold since 1975 and now comprise 13.5 percent of Chile's foreign sales. The US Embassy and reliable press sources report that this phenomenal rise has been due, in large part, to benefits Santiago has lavished on the agricultural sector in the form of extensive subsidies, tariff protection, and concessionary financing. Santiago plans to continue these policies for the near future, and we believe they will help to consolidate recent gains. We also judge that continued plantings of apple orchards and vineyards, along with the replacement of wine grapes with the more lucrative table variety, promise a robust future for Chilean agriculture. 25X1

Chile exports agricultural products mainly to the United States, Europe, and the Middle East. Chile's earnings in this sector, however, have suffered from the poor prices it receives in the European Community, and the US Embassy reports that the government plans to market aggressively in the United States and Pacific Rim countries. According to press reporting, US fruit growers do not object to Chilean fruit exports because they do not compete directly in their product season. Chile's Southern Hemisphere growing season has helped it sell nearly half of its total fruit exports to the United States. Nevertheless, Santiago is beginning to export processed fruits—such as apple juice concentrate and dried fruits—and is constructing cold storage facilities, portending possible efforts to penetrate the US market during the Northern Hemisphere growing season. 25X1

Fishing. Over the last decade, Chile has become the world's fourth-largest exporter of fish and the largest 25X1
exporter of fish meal, and the government hopes to almost triple revenues by the end of the century. The US Embassy reports that future catches, however, may be reduced by a three-year moratorium on fleet expansion imposed by the government to prevent the depletion of the northern fishing beds. Expansion of the fishing industry will depend on exploitation of the less-fished southern regions, as well as on more catches of edible fish (as opposed to the fish meal catch) and the development of aquaculture. Because 25X1
the fishing industry is capital intensive, growth will also hinge on new investment to upgrade the fleet and develop canning and freezing facilities. 25X1

Chile plans to cultivate new markets for its fish products. Currently, the bulk of Santiago's revenues come from fish meal sales to Germany, China, the United States, and East Germany. The press reports that Santiago intends to increase sales of edible fish to these countries, while penetrating markets in Japan, Malaysia, Singapore, Spain, and South Africa. 25X1

Figure 3. Chile is diversifying its exports.

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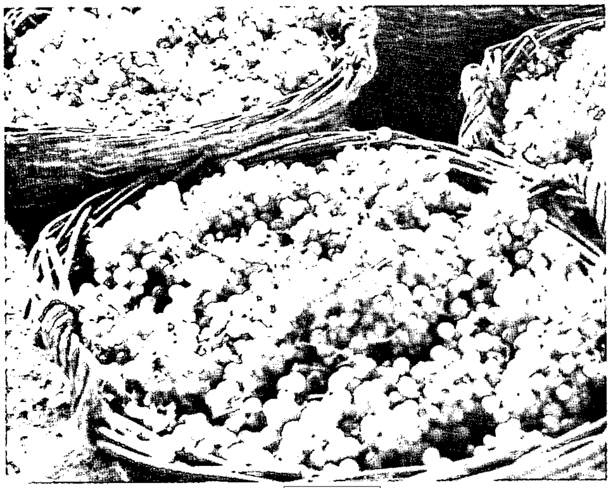
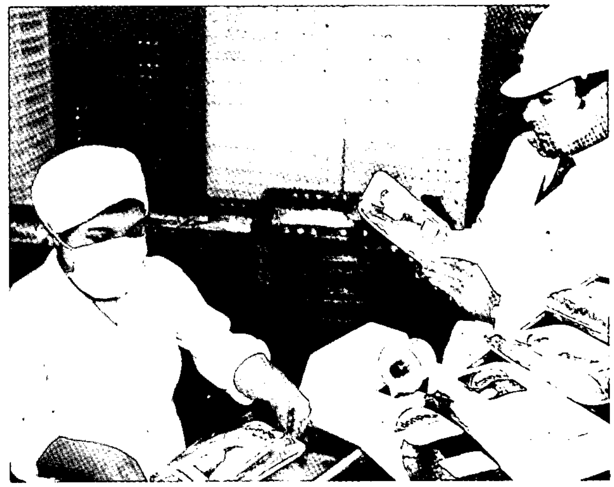


Tablegrape harvest for export.



Chile is encouraging the processing of edible fish to help increase the value of its fish industry exports.

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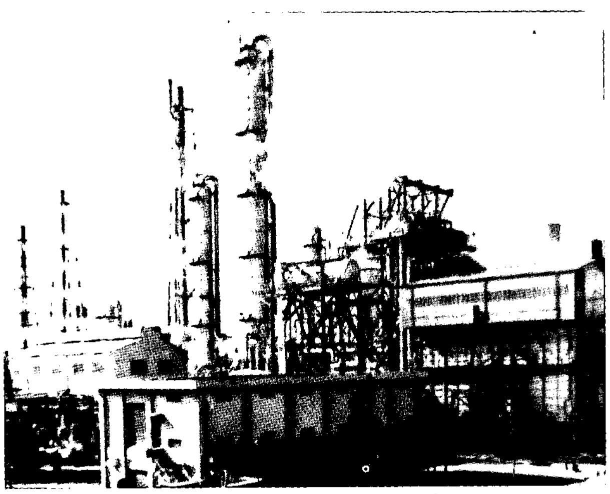

A methanol plant similar to the facility currently under construction by Signal Methanol company near Punta Arenas.

Government and private interests are joining hands to improve the quantity and quality of Chile's exportable lumber.

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This strategy will hinge on adequate investment flows. Because of their dearth of loanable funds and inexperience in this area, domestic banks will probably remain small players in the fishing industry, with the result that Chilean fishing will remain heavily dependent on support from CORFO—Santiago's industrial promotion agency—and the Inter-American Development Bank. The government, however, may try to reduce the industry's dependence on foreign investment by encouraging domestic boat manufacturing. Additionally, the industry could be assisted by joint fishing ventures similar to those presently under way with Japan, Korea, and Spain. [redacted]

Wood Products. A major expansion of tree acreage in the late 1970s has boosted forestry-related exports, although Chilean sales still comprise less than 1 percent of the world total. Santiago intends to triple exports by the end of the century, according to press reports. Although the government subsidized plantings in the past and will continue to do so, the expansion plan calls for an additional $3.1 billion in foreign and domestic investment over the next 15 years. These funds will go to the development of processing plants, plantations, transportion networks, and energy sources. A forestry investment committee composed of government and private companies will establish investment priorities. Santiago is using World Bank and Inter-American Development Bank loans to help implement the program, but we believe it will be hard pressed to obtain the additional foreign and domestic investment required for continued rapid growth. Chile's uncertain political future will make it unattractive to private entrepreneurs, in our view, because investments in forestry can take decades to pay off. [redacted]

Chile's main wood export is pulp, but it is pushing sales of sawn lumber, plywood, and paper. Poor forestry techniques have resulted in low-quality pine, and it will take several years before methods now used will produce higher quality lumber. The Pacific Rim countries absorb over a quarter of Chile's wood exports, while nearly 20 percent goes to other South American nations. Chile's small share of the overall world market will continue to shape its strategy; it will market future production in areas it knows best, such as South America and China. [redacted] 25X1

Military Sales. Over the past decade, Chile's arms industry has risen from obscurity to become the fifth largest—and probably the fastest growing—of Santiago's export sectors. The Chilean military has developed its domestic arms industry by negotiating licenses to produce Western-designed equipment of intermediate technological sophistication. These arms are initially produced, tested, and refined by the Chilean military. The finished product is then marketed to Third World consumers, who have found them easy to use and maintain, according to press reports. [redacted] both military-owned companies and private firms—some of which receive government subsidies and technical support from the armed forces—manufacture and export arms. [redacted] 25X1 25X1 25X1

Santiago's biggest money earner so far has been the cluster bomb—produced and sold by two private companies with technical assistance from the military; Chile sold over $120 million in cluster bombs to Iraq in 1985, according to press reporting. Arms sales to Iran, Egypt, Pakistan, and Thailand may have added another $100 million, [redacted] 25X1 25X1

Santiago, according to press reports, is trying to develop markets for other domestically produced military items such as a trainer aircraft, armored personnel carriers, antiaircraft guns, conventional bombs, landmines, and small munitions. Production of helicopters and gunboats is scheduled to begin soon, and these are also likely to be marketed abroad. Moreover, Chilean engineers have made advances in the field of military electronics. One company—ASMAR—manufactures radars and recently designed a computer-assisted VHF jamming system, and another is developing heat-seeking missiles. [redacted] 25X1 25X1

Major Chilean Arms Manufacturers

Manufacturer	Products
AeroIndustries	Aircraft target bombs.
ASMAR	LSTS, patrol craft, search and rescue craft, SAAR-class missile attack craft, radars, shipboard electronics.
Cardoen Industries [a]	Cluster bombs, fragmentation bombs, general purpose bombs, VTP-1 "Orca" multipurpose vehicle, VTP-2 "Escarabajo" multipurpose troop transport, BMS-1 "Alacran" half-truck, Piranha multipurpose armored vehicle (under license from Swiss firm Mowag), helicopter gun mounts, 70-mm rockets, grenades.
Chilean Military Industry and Engineering Complex (CQIE)	Aerial bombs.
National Aeronautics	Pillan T-35 basic trainer, Aucan turboprop trainer, Halcon T-36 jet trainer (under license from Spanish firm CASA), BO-105 helicopter (under license from West German firm MBB), F-5 spares, onboard electronics.
Army Materials and Arsenals Factory (FAMAE)	Small caliber weapons and ammunition, infantry support weapons, grenades, mines, aerial bombs, mortars, 105-mm ammunition.
FAMIL	20-mm antiaircraft artillery.
FERRIMAR	Iron bombs, cluster bombs, submunitions.
SOGECO	Antiaircraft guns and mounts.

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[a] See following page for photo examples.

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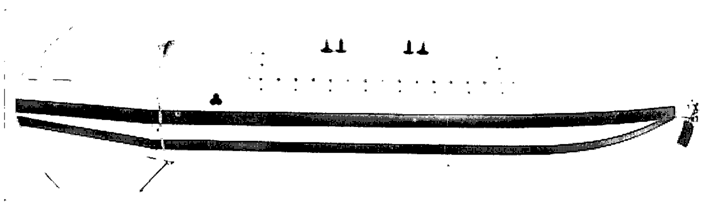
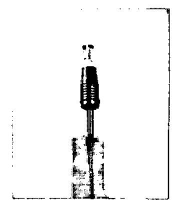
In our view, Chile is in a good position to expand its arms exports by offering countertrade, service, and coproduction agreements. Cardoen Industries—Chile's largest private arms manufacturer—has built or is building cluster bomb factories in Iraq and Spain, and is assembling Spanish-supplied aircraft parts for reexport, according to the press Military journals report that Chile is also planning to modify and produce West German BO-105 helicopters under license for civil and military uses and to begin assembling and eventually producing German SIG-540 rifles.

Although private companies such as Cardoen have successfully marketed their own goods, several firms have decided to use the Spanish firm Spanco and individual arms dealers as intermediaries.

Export Promotion and Incentives

Santiago plans to expand its present line of exports in the short run, while working to develop new product 25X1
lines over the long term, according to US Embassy reporting. The government, while continuing to help 25X1
major exporters, will soon begin providing smaller exporters with marketing assistance and loans from multilateral bank programs. In the past, small Chil- 25X1
ean manufacturers have lacked both the resources and the expertise to reach distant markets. The government is rectifying this problem through new laws allowing small producers to form marketing consor- 25X1
tiums and by granting rebates and tax refunds on imported goods used in producing exported products. 25X1
Additionally, the Chilean business press reports that

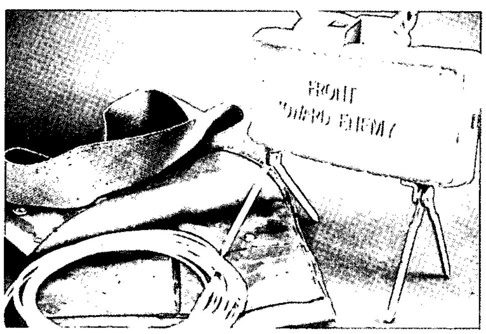
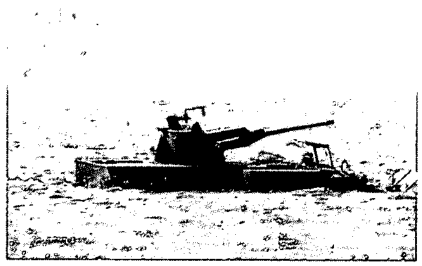
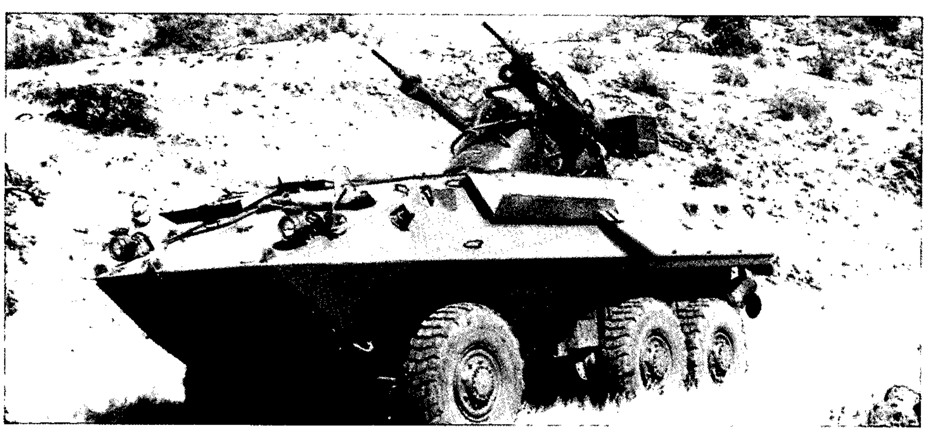
Figure 4. Examples of arms made by Chile's chief producer—Cardoen Industries. 25X1

(Left) 500-pound cluster bomb 25X1

(Right) One of 240 bomblets packed into the cluster bomb 25X1

Cohete 70-mm unidirectional rocket 25X1

(Left) M-18 anti-personnel mine 25X1

(Right) Piranha 6x6—fully amphibious (in water view) 25X1

(Below) Piranha 6x6—(on land view) 25X1

the government export promotion agency intends to contribute by providing insurance and regulatory information on foreign markets, and arranging for new exporters to exhibit at trade fairs.

Stumblingblocks

Chile's export promotion program, in our view, is realistic, well thought out, and comprehensive in scope. It is being competently implemented by one of the most skillful and least corrupt bureaucracies in South America. Moreover, while the plan makes ample use of government subsidies and production incentives, it has avoided a rigidly statist or nationalist approach that would stifle private-sector initiatives and work against foreign participation. Nevertheless, Santiago must overcome several obstacles—notably a low savings rate, unpredictable access to foreign funds, and volatile world markets—if exports are to keep growing over the next several years.

The main precondition for a successful export drive, in our view, is Santiago's adherence to policies that will increase savings—needed to raise domestic investment capability—and foreign investor participation. The commitment to facilitate investment, however, may falter under the weight of competing interests and pressures. For example, according to Embassy reporting, the government has already tried to assure continued political support from major domestic cartels by lowering interest rates—a move we believe undermines the generation of new savings. Politically influential bankers—fearing dilution of their ownership and control of the financial system—will probably also fight to derail the measures that Santiago has taken to recapitalize Chile's largely insolvent banks and bolster the domestic financial sector. Moreover, in our view, the government will find it increasingly difficult to continue restricting domestic consumption in favor of new investment over the next two years as the middle and lower classes begin complaining about a decline in government services and a shortage of consumer credit.

Santiago, however, can probably increase savings by reducing the growth of its debt servicing burden. Its debt-to-equity conversion program begun in 1985—converting foreign debt to shares in domestic enterprises—could reduce the growth of its overall debt burden by nearly $1 billion by 1987, by our calculation. Santiago also hopes to shift its borrowing from commercial banks to multilateral banks charging lower interest rates. We believe this strategy will slow the growth in Chile's debt service and help its balance of payments, giving some counterweight against other policies that discourage the generation of investment funds. 25X1

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According to the US Embassy, Santiago is counting on foreign sources for over half of the investment required by the export program. Foreign commercial lending and investing, however, may be hurt by creditor concern that Santiago's human rights record and its failure to move forward on a transition to civilian rule could sour its relations with international financial institutions and possibly provoke economic sanctions, according to the press 25X1 Although we believe that the chances for South 25X1 African-style sanctions are slim, a vote by industrialized nations against Chilean World Bank and Inter-American Development Bank loans could seriously jeopardize many aspects of the export promotion program. In our view, uncertainties about Chile's future will cause investors to hold back for the next several years unless commodity prices rise enough to cover the immediate risks associated with political instability or sanctions against the Pinochet regime and the longer term threat that a post-Pinochet government could change investment laws.[1] 25X1

Chile's program is also predicated on commodity prices either stabilizing or rising. This will require increased demand in the industrialized countries and easing interest rates to encourage inventory restocking. Otherwise, commodity prices could decline to the

[1] Currently, Chile is not facing a capital flight problem. Strong economic management and high real interest rates paid by the Central Bank on dollar accounts have helped stabilize Chile's capital flows. However, capital flight could be triggered by increasing political instability or a veto of Chile's pending development bank loans. 25X1

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Figure 5
Chile: Outstanding External Debt, 1981-85[a]

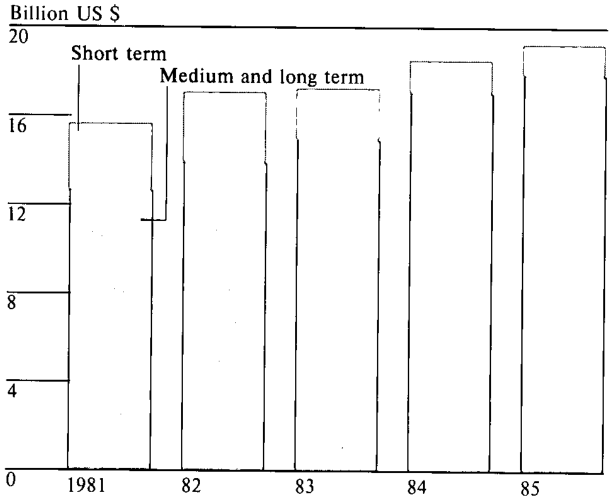

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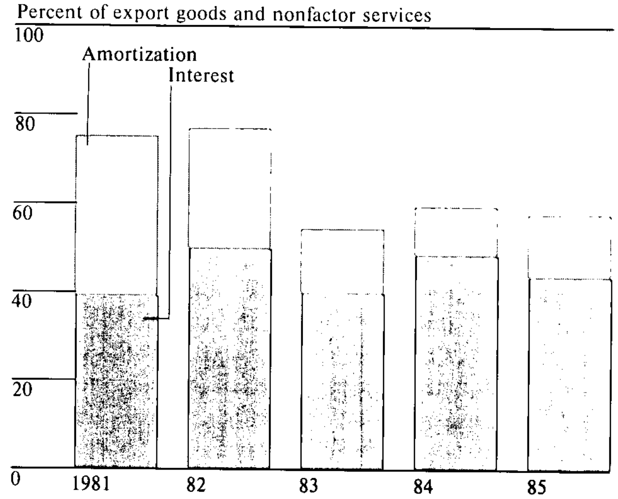
Figure 6
Chile: Debt Service After Completing Rescheduling Agreements, 1981-85



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point where no attainable increase in export volume by Chile would compensate for lost revenues. Chile will also face the danger that small price increases for some of its exports could encourage competing producers to enter the market—creating excess supply and precipitating another drop in prices.

Finally, even if Chile can expand production of its exports, it must quickly carve out a niche for them in the world market. While we believe that Santiago is, on the whole, effectively targeting new customers, increasing protectionism and fluctuating exchange rates in the EC and the United States may serve to impede growth in several areas:

- EC agricultural tariffs will hamper the expansion of fruit exports, but a falling dollar against European currencies could increase the continent's demand for Chilean copper.
- Santiago's self-imposed restrictions on copper exports to the United States will reduce the growth potential of this market.
- Chile's fruit sales to the Middle East probably will not expand as long as oil prices remain depressed. 25X1
- Chile will need several years to fully develop the Far East market, which we see as containing its best potential customers for fruit, fish, and wood products.
- Arms sales, however, are poised to take off, as Santiago has several quality products ready for export and is targeting a Third World market eager for the mid-technology, low-priced items it produces. 25X1

Figure 7
Chile: Export Shares by Region, 1975 and 1985

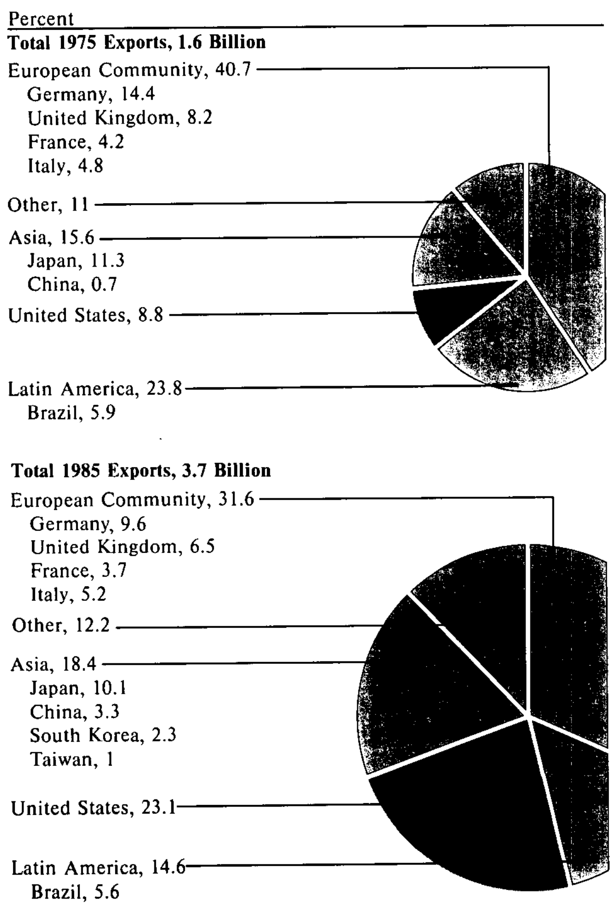

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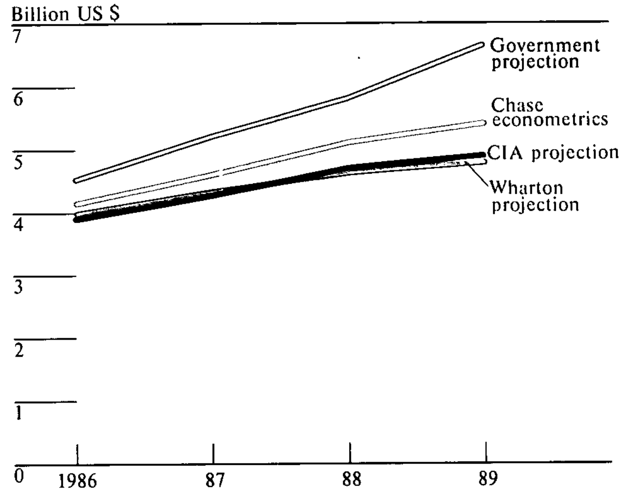
Figure 8
Chile: Comparative Projections of Exports, 1986-89



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Outlook

Prospects for Chile's export program depend to a considerable extent on the way political events play out, and we see several possible eventualities that could undo the program. A move by Pinochet, for example, to spur consumption to curry political support before the 1989 presidential plebiscite might generate a brief economic surge, but it would probably gut domestic investment—and with it the chances for sustained, export-led growth. Likewise, continued refusal by the regime to advance toward civilian rule or to curtail human rights abuses could reduce Chile's access to foreign funds, with equally adverse effects for the export program. We believe that commercial banks, for instance, will defer rescheduling talks on Chile's debt until they are reassured that multilateral financial institutions will not try to apply political pressure on Pinochet by lowering commitments to Santiago. The program, in our view, could be jeopardized if external credits were delayed for as little as six months. 25X1 25X1

On economic grounds alone, we doubt that the trade expansion program will meet the government's target of roughly 13-percent annual growth in exports during 1986-89. Rather than rising sharply—as Santiago expects—prices for Chile's export commodities will probably increase only modestly at best, dashing both investor enthusiasm in the export sector and the government's hopes for a sustained investment boom over the next several years. In addition to their direct effect in reducing momentum of the export program, sluggish investment and limited commodity price rises would force Chile to ask bankers to reschedule its maturities and supply new loans through 1989 to cover its balance-of-payments shortfall. We believe bankers would acquiesce in such requests—albeit not without some foot-dragging—but, having done so, they would not then be likely to extend loans for projects directly related to the export expansion program.

Nevertheless, we believe that the momentum generated in the export program to date—coupled with modest levels of domestic investment and stabilizing commodity prices (see appendix A for export revenue projections by commodity)—should be sufficient, in the absence of adverse political developments, to allow growth in the export sector to average roughly 7 percent a year through 1989. Such growth in exports would help keep the overall economy expanding at an annual rate of between 2 and 4 percent and would generate enough foreign exchange to keep Chile's new money needs at a level that would avoid serious confrontations with creditors. Moreover, even the relatively modest growth that we project would benefit the domestic economy by giving small businesses a stake in the export program and promoting the growth of a more aggressive entrepreneurial class. Such a strengthening of the private sector would lessen the likelihood that Chile would revert to its traditionally statist and inward-oriented economic policies when the country returned to civilian government.

We doubt that modest success of this sort in the export program will alleviate any of Pinochet's political headaches over the short term. Only a highly unlikely economic boom—similar to that of 1978-81—would, in our view, significantly boost Pinochet's popular support and reduce the public's desire for a speedy return to civilian rule. Moreover, while annual growth in the export sector above 7 percent will create jobs in primary-product sectors, employment in areas such as services and manufacturing—the locus of many politically active unionized workers—may languish or decline. The generally conservative rural areas should benefit from the strong push for agricultural exports, but unemployment could actually rise in the strongly anti-Pinochet shantytowns that ring Santiago and other major cities. We believe that under these circumstances popular discontent with Pinochet will grow, fueled primarily by a general desire for a transition to democracy. A unified call by moderate political parties last year for such a transition and significant mass participation in an antiregime protest strike this year have helped, among other factors, to create a political momentum in the anti-Pinochet movement that, we believe, is largely impervious to modest improvements in the country's economic situation.

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Implications for the United States

Even moderate success by Santiago in spurring export-led growth will, in our view, provide US bankers and other foreign creditors with a more sound backdrop for lending and investment. Although Chile's greater capacity to service its debt will benefit US bankers—who hold one-half of the commercial loans to Santiago—the export program may hurt other US economic interests. Increases in copper production in Chile, for example, probably will keep international prices too low to make the reopening of US copper mines profitable. We expect that the emphasis by Chilean growers on cold storing and processing their fruit will put them into direct competition with US producers, creating the potential for trade disputes similar to those in which Santiago is already embroiled with the EEC.

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Chile's growing arms exports may also run counter to US foreign policy interests. Chile is willing—and increasingly able—to export basic arms to virtually any country that can pay cash. Recently, demarches by Washington and Iraq failed to dissuade Santiago from selling cluster bombs to Iran. We anticipate more such sales and doubt that Santiago—given its need to export and its already strained relations with Washington—will respond readily to US pressure in this area. 25X1

Marginal growth over the next several years will help Pinochet only in a limited way; the economy at least will not become still another issue compounding his already formidable political problems. Nevertheless, we doubt that export-led growth will significantly bolster Pinochet's political standing or work against US encouragement of a transition to civilian rule. Nor will it, in our view, dampen the political unrest fueled by popular support for Pinochet's departure from office when his term expires in 1989. Should the President remain unyielding on a transition formula, however, there is a danger that domestic unrest, a reduction in investment flows by nervous foreign creditors, or even external sanctions could derail the export program, thereby aggravating both political and economic instability. 25X1

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Appendix A

Export Projections by Product Group and Subproducts, 1984-89

Table A-1
Major Minerals and Basic Mineral Products

Million US $

	1984	1985	1986	1987	1988	1989
Total	**2,227**	**2,361**	**2,443**	**2,553**	**2,699**	**2,820**
Percent change	**−13.7**	**6.0**	**3.5**	**4.5**	**5.7**	**4.5**
Copper products	1,614	1,782	1,871	2,002	2,142	2,228
Percent change	−13.2	10.4	5.0	7.0	7.0	4.0
Molybdenum	107	91	93	94	96	98
Percent change	−14.6	−14.9	2.2	1.1	2.1	2.0
Iron	134	117	119	120	121	122
Percent change	−7.8	−12.7	1.7	0.8	0.8	0.8

Table A-2
Major Agricultural Products

Million US $

	1984	1985	1986	1987	1988	1989
Total	**407**	**499**	**599**	**719**	**841**	**984**
Percent change	**35.9**	**22.7**	**20.0**	**20.0**	**17.0**	**17.0**
Fresh fruit	294	368	452	556	667	801
Percent change	33.2	25.2	22.8	23.0	20.0	20.0
Grapes	165	219	284	369	462	577
Percent change	31.0	32.7	29.7	30.0	25.2	25.0
Apples	75	77	84	94	105	118
Percent change	18.5	2.7	9.1	12.0	11.7	12.4
Pears	11	14	19	22	24	27
Percent change	22.6	27.3	35.7	15.8	9.1	12.5
Peaches and nectarines	19	21	23	25	27	31
Percent change	118.6	10.5	9.5	8.7	8.0	14.8

Table A-3
Marine Products

Million US $

	1984	1985	1986	1987	1988	1989
Total	**442**	**458**	**476**	**500**	**520**	**540**
Percent change	**8.7**	**3.6**	**3.9**	**5.0**	**4.0**	**4.0**
Fish meal	276	275	280	282	286	297
Percent change	−10.0	0.0	1.8	0.7	1.5	3.8
Frozen fish	76	73	74	82	90	101
Percent change	1.0	−3.9	1.4	10.8	9.7	12.2
Fish oil	29	36	41	43	46	49
Percent change	133.6	24.1	14.0	5.0	7.0	6.5
Canned fish, mollusks, and crustaceans	40	41	43	45	48	52
Percent change	29.8	2.5	5.0	4.6	6.7	8.3

Table A-4
Forestry Products

Million US $

	1984	1985	1986	1987	1988	1989
Total	**382**	**335**	**368**	**412**	**454**	**499**
Percent change	**17.2**	**−12.3**	**9.8**	**12.0**	**10.2**	**10.0**
Cellulose	200	151	168	186	204	225
Percent change	25.0	−24.5	11.2	10.7	9.7	10.3
Sawn wood	74	55	56	57	58	65
Percent change	12.6	−25.7	1.8	1.8	1.8	12.0
Roundwood logs	30	40	52	57	63	72
Percent change	−12.1	33.3	30.0	9.6	10.5	14.3
Newsprint	40	49	59	72	80	90
Percent change	34.2	22.6	20.4	22.0	11.1	12.5

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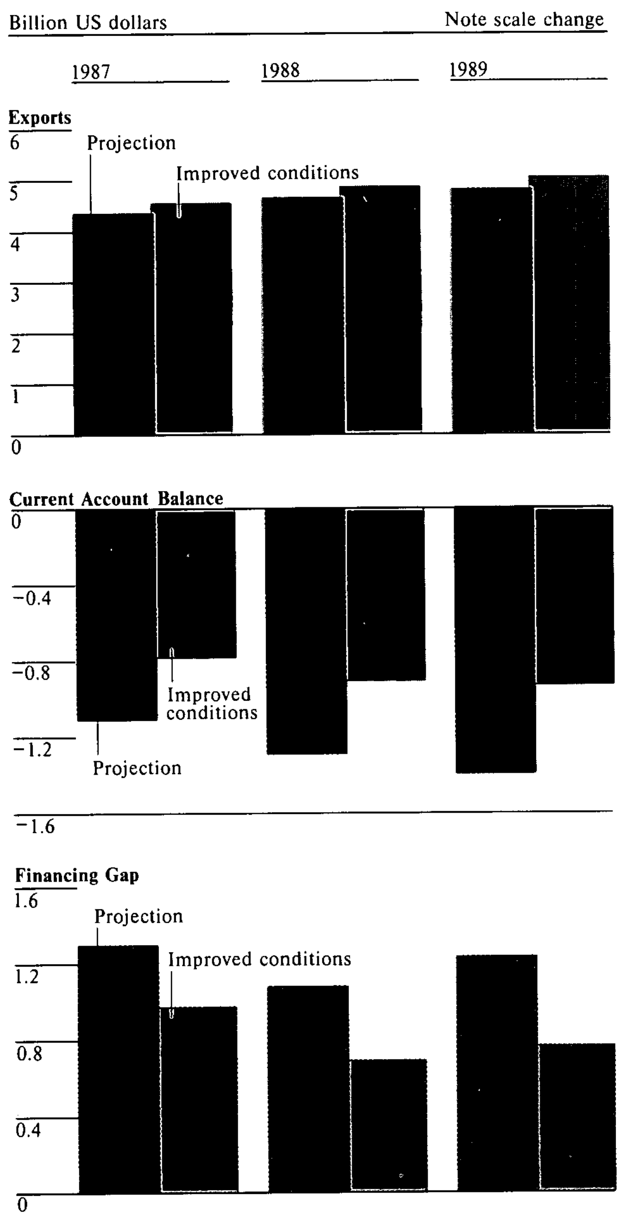
Appendix B
Wharton Country Monitor
Financing Gap Forecast[a]



Note: "Improved conditions" means that copper prices rise 10 percent faster and interest rates fall by 1 percent more than anticipated.

[a] The sensitivity analysis above was conducted against projections made by the Wharton model.

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