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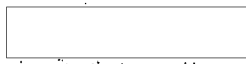
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DIRECTORATE OF INTELLIGENCE

20 November 1987

Chile: Prospects for the Free Market Economic Model



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Summary

President Pinochet is widely recognized as a strong supporter of a free market economy, but we believe that his support is based largely on pragmatic rather than ideological grounds. We judge, therefore, that he will take whatever economic course is most expedient should domestic or international pressures threaten his regime. Although we believe Pinochet will increase government spending somewhat as he campaigns for the presidential plebiscite slated for late 1988, Finance Minister Buchi will likely maintain Chile's excellent relations with creditors and keep the economy from overheating.



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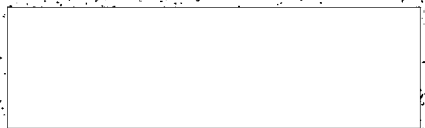
Political uncertainties following the plebiscite, however, cloud the economic horizon. We believe that major shifts in economic policy are least likely if

This typescript was requested by Mr. John Bohn, Chairman, EXIM Bank. It was prepared by [redacted] South America Division, Office of African and Latin American Analysis. This paper was coordinated with the Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, South America Division, ALA, [redacted]

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Pinochet wins the plebiscite without massive fraud or if he is succeeded by a conservative acceptable to the moderate opposition. Other potential outcomes would increase the danger to the regime and multiply the odds that Pinochet will veer off his current economic course. Should Pinochet engineer a clearly fraudulent win or take unconstitutional actions to maintain himself in power, domestic violence and international pressures for his removal could encourage him to spend freely to shore up his political position, throwing Chile into a bout of inflation and stagnation. Finally, effective trade and financial sanctions could impel Pinochet to change his economic course and institute a policy of semi-autarky that could jeopardize growth and lead Chile to repudiate or suspend payments on its foreign debt. [redacted]

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Pinochet: Pragmatic Free Marketeer

President Pinochet adopted a free market economic philosophy shortly after the 1973 coup that brought him to power. Inheriting a failing economy registering 1000 percent inflation, he turned for help to a group of young economists educated at the University of Chicago. The "Chicago Boys," as they came to be known, had, during the Allende years, prepared a detailed economic plan for any successor government; Pinochet and the Junta chose to administer it--at first gingerly, but by 1975 with more vigor. The policies, which centered on market freedom and a reduced government role in the economy, generated sharp reductions in inflation and the highest per capita economic growth in Latin America during the late 1970s. [redacted]

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The success of free market policies in generating growth and removing the economy as an effective vehicle for political opposition to the regime made Pinochet an advocate of an open economy, but we believe his loyalties are primarily pragmatic, rather than ideological. In the wake of the 1982-83 recession, he turned to more state participation in the economy and freer government spending to generate rapid growth and undercut growing political opposition. Less than a year later, when domestic pressures had been deflected and high spending was generating reluctance among international bankers to continue needed external financing, Pinochet installed a new economic team under Finance Minister Buchi and returned Chile to strict free market policies. Drawing from this experience, we believe that if the regime is endangered by domestic political problems or

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international pressure surrounding the upcoming plebiscite*, Pinochet will not hesitate to move policy in any direction he feels will preserve him in power. [redacted]

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Domestic Pressures Before the Plebiscite

Unless Pinochet's political position in the months leading up to the plebiscite unexpectedly weakens to the point that his chances of receiving the nomination begin to evaporate, he will probably not effect any major changes in Chile's economic policies. We believe that over the next year Pinochet will give Buchi wide leeway to react to changing conditions in order to maintain economic stability. In an April conversation with the US Ambassador, Buchi characterized Pinochet as very cautious about programs that might destroy the government's image of fiscal responsibility. [redacted]

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On the other hand, while we do not expect wholesale pump priming that might jeopardize Buchi's approach, we believe Pinochet is prepared to use some economic tools to attract voters. For example, he recently announced a plan to create 50,000 additional public works jobs, increase pension payments, and improve job protection for teachers and civil servants. Moreover, Santiago implemented a 16-percent pay hike for government workers several months earlier than normal and intends to augment subsidized housing starts by 25 percent this year. The housing program is highly visible and closely identified with Pinochet and, according to the US Embassy, has won him some political support among the poor in recent years. [redacted]

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In the unlikely event that Pinochet's political fortunes show no measurable improvement over the next year--polls currently place him in a 12 to 22 percent public approval range--he might be tempted to overspend massively, which would send Chile into high inflation and unsustainably rapid growth. Uncontrolled domestic inflation would run Chile afoul of its international creditors and jeopardize its important export promotion program. Unrestrained growth would almost certainly be followed by recession. We judge this scenario to be unlikely because Pinochet, if indeed nominated for the plebiscite, can probably count on receiving a substantial share of the popular vote--although we believe not a majority. In those circumstances, the regime would likely turn to fraud, rather than massive pump priming, to put him over the top. [redacted]

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* According to the 1980 Constitution, a plebiscite must be held by 10 February 1989 to approve a candidate for president who will serve until 1997. The plebiscite may be held earlier, however, and the most often discussed date is 11 September 1988. [redacted]

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Economic Implications of the Plebiscite

The possibility of significant economic policy change increases after the plebiscite, however, particularly if Pinochet faces stronger political opposition and mounting international pressure. The political impact of the plebiscite on the economy will depend on a variety of factors, including who the candidate is, whether he wins (or loses) fairly or fraudulently, and the reactions by the public, the major opposition parties, and Pinochet to the outcome. Although these variables can yield a number of post-plebiscite scenarios for the period 1989-1990, they fit into two categories: those that leave Chile fairly stable with either Pinochet or a new president firmly in control of the government and faced with manageable socio-political dissidence, and those that usher in a period of instability and uncertainty. The outlook for Chile's continued adherence to a rigorous free market economic model are substantially different for each category. [redacted]

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Political Stability. Should Pinochet win the plebiscite without engaging in massive fraud and in the context of general political apathy and a divided opposition, we believe he would have no incentive to change his basic approach to economics. He would probably conclude that the free market model had contributed to his victory by continuing to generate enough growth to prevent the opposition from exploiting economic problems for political ends. [redacted]

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Although the constitution mandates that a congress must be elected 30 to 45 days before 11 March 1990, we doubt that a legislative body would generate much pressure for a change in economic policy. After a clear-cut plebiscite victory, Pinochet, in our opinion, would dominate a politically impotent and disorganized opposition that would almost certainly lack the congressional strength to challenge the President on important issues. Under any circumstances, but most certainly in the wake of a questionable victory, Pinochet would likely use every resource, including his right to appoint one third of the senate, to limit the effectiveness of congress. Should a consensus candidate win, we expect that the skimpy powers allotted to the congress in the 1980 constitution would prevent it from independently implementing any major economic policy changes. [redacted]

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We believe that the outcome most conducive to relative political stability would be Pinochet's replacement as plebiscite candidate by a military officer or civilian acceptable to the moderate political opposition and pledged to undertake democratic

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reform.* Under such circumstances, Chile's economic policy would most likely remain fairly constant, at least over the medium term. Conservative politicians and the military would carry the most weight in the selection of a consensus candidate, and they would almost certainly insist on leaving the major features of the current model intact, particularly during a two or three year transition period to full democracy. According to US Embassy reporting, Chilean businessmen are primarily concerned about maintaining the state's limited role in economic activity and obtaining firm guarantees regarding property rights. Although economists at private think tanks often critical of the government have touted more populist programs involving higher social spending and boosts in real wages, we doubt they would be able to impose more than incremental changes in economic policy in an administration dominated by center-right parties and politicians. [redacted]

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Post Plebiscite Turbulence. We believe that any plebiscite outcomes that undermined Pinochet's legitimacy and energized the moderate opposition and the radical left would significantly raise the odds that the President would turn away from the economic approach of the past decade. In our view, the most likely of these scenarios is one in which Pinochet engineered a plebiscite victory through massive fraud in the face of a relatively united opposition and a politicized public. Even if successful, overt electoral chicanery would probably ignite widespread anti-Pinochet demonstrations and spur the far left to increase the level of terrorist violence. The intensity of opposition--both domestic and international--to the regime, in our view, would increase as Pinochet's intention to keep power in defiance of the people--and, perhaps, of the constitution--became more blatant. We believe that one of the most potentially explosive of these scenarios would be one in which Pinochet moved to maintain power following a plebiscite defeat by abrogating the constitution and ruling with the Army alone--the so-called "self-coup" (auto-golpe) option. A brazen act of this nature might convince many moderates that the only way to oust Pinochet

* Over the past two years, several prominent conservative political or business leaders have surfaced as possible compromise candidates, ranging from former cabinet members and close Pinochet advisers, such as one time Foreign Minister Hernan Cubillos and former Interior Minister Sergio Jarpa, to the leader of Chile's principal businessmen's association, Manuel Feliu. Other possibilities include military officers such as the Army Vice Commander, General Santiago Sinclair; the Army representative on the military junta, General Humberto Gordon; or former General Gaston Frez, who occasionally spoke out against Pinochet until he was forcibly retired from the Army in 1986. At this juncture, no one has the inside track. [redacted]

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was by making common cause with the left--a recipe certain, in our view, to intensify political polarization and violence while isolating the regime. [redacted]

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Under any of these scenarios, we believe Pinochet would eventually succumb to the temptation of manipulating the economy to shore up his political position. We would expect him to act as he has in the past: using economic largess to neutralize individual groups and to halt or diminish their overt opposition to the regime. Such an effort to buy off specific groups, however, runs the risk of spending Chile into an inflationary spiral that would undermine the course of stable growth advocated by Buchi. Excessive spending could encourage Buchi to withdraw from the Finance Ministry, undermining the confidence of the domestic and international business communities. Increased domestic turbulence of any sort, moreover, is likely to lead to production cuts by foreign-owned firms and reduced investment at home and from abroad, presaging a decline in growth for 1989 and the early 1990s. [redacted]

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The Effect of External Economic Factors

External factors are working to Pinochet's advantage and will likely continue to do so over the medium term, permitting growth of about 5 percent through 1988 with only a moderate slowdown to 3-4 percent during the following year. Santiago's trade accounts are currently benefiting from unusually high copper prices that are generating export growth of at least 20 percent, while heavy inflows of capital goods are pushing imports up by more than 30 percent. We expect that favorable exchange rate policies will keep export volumes high through 1989, but that an anticipated fall in copper prices will slow the growth of export earnings to 8-10 percent yearly. We also believe that the economic team will constrain the growth of imports to about 5-7 percent yearly by 1989--enough to allow economic growth without jeopardizing Chile's trade balance and ability to service its debt. [redacted]

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Buchi has also made commendable progress in overcoming Chile's debt difficulties, having arranged a 1987-88 rescheduling with commercial bankers and the Paris Club that obviated the need for new loans before 1989. Chile is in good standing with the IMF and the World Bank, and we expect it to seek a new program with the Fund and additional World Bank loans when the current Extended Fund Facility and the World Bank Structural Adjustment Loans expire next year. [redacted]

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[redacted]

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A domestic political crisis in the wake of the plebiscite, however, would create conditions under which external factors would have an adverse impact on the Chilean economy, most likely by setting off a renewed international drive for economic sanctions to force Pinochet to speed up the transition to full democracy. Sanctions would probably take the form of barriers to trade, such as an embargo against Chilean copper, or moves to deny Santiago access to multilateral development bank lending. In the immediate wake of such actions, we expect Pinochet would again react by emphasizing Chile's record as a model debtor and exemplar of free market economics, and by making a few, mostly cosmetic, political concessions. In the short term, however, we believe that Pinochet could parry the proposed sanctions only by stifling any post-plebiscite tumult promptly and by scrupulously avoiding egregious human rights abuses. [redacted]

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If sanctions were imposed and were able to take hold, however, we judge that they would have a significant effect on the Chilean economy, with some serious problems appearing within the first year. Chile, in our view, is extremely vulnerable to a trade embargo by Western countries of its major exports, and would not be able to locate and develop new markets quickly enough to avoid severe domestic dislocations. Moreover, the current economic model's heavy dependence on multilateral development funds means that a cut-off of these loans would promptly slow--and perhaps reverse--economic growth. Commercial bankers, who until now have favored Chile, would probably begin to withdraw their support after concluding that trade and financial sanctions had substantially increased the risks of doing business with Santiago. [redacted]

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We believe that such a harsh international environment could easily lead Pinochet to change course entirely and turn the economy toward autarky in order to make the best of Chile's isolation. Buchi and other supporters of the free market would no doubt resign and be replaced by advocates of a dominant economic role for the state. In our view, the reorientation of the economy to serve domestic needs and to replace imports might generate a year or two of anemic growth as the government fostered new industries. Ultimately, however, Chile's small home market, inefficient and costly industrial sector, and lack of access to foreign capital and technology would lead to stagnation, inflation, and a weakened economy. [redacted]

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Implications for the United States

We believe that if Pinochet wins the plebiscite cleanly and there is little or no subsequent political agitation, Chile's cordial relations with US creditors and healthy trade with the United States--Santiago will import nearly \$900 million in US

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goods this year--are likely to remain intact. If Pinochet is replaced by a conservative consensus candidate, we believe that the impact on US economic interests would also be minimal. Although a successor might spend slightly more than Pinochet on social programs or provide some additional protection to domestic producers, we doubt that he would change the basic features of the current economic model, with its openness to US investment, favorable debt-to-equity swap regulations, and conciliatory approach on the foreign debt. [redacted]

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Scenarios that lead to significant political tumult and more populist economic policies, however, could harm the US commercial stake in Chile. Widespread violence and strikes following the plebiscite would almost certainly cause US businessmen to reassess their trade and investment exposure in Chile, especially if Pinochet departed significantly from the free-market model in order to curry favor with specific interest groups. Moreover, the trade and financial sanctions that we anticipate under these conditions would reduce Santiago's access to foreign funds and slash export earnings. Under these circumstances, we believe that Pinochet would eventually feel justified in suspending or, in the worst case, repudiating payments on the foreign debt. [redacted]

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- Annex 1

Chile's Economic Model

The Chilean economic model is strongly pro-free enterprise, with the government playing a limited role in decentralized decisionmaking. Since 1985 an aggressive export expansion program--financed largely by multilateral development banks--has been driving growth. Furthermore, a deliberate rejection of economic nationalism has created a favorable environment for foreign investment. In our view, the current economic team, which has been on board since February 1985, demonstrates sound economic management and is pursuing a sustainable level of growth based on investment rather than temporary, consumption-led surges in economic activity. [REDACTED]

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The model has generated four consecutive years of economic growth--real GDP was up by 5.7 percent in 1986 and projected growth this year will be of the same order. Chile's economic adjustment program is, in our judgment, the most effective among the South American debtors in maintaining relations with commercial creditors and multilateral lenders. Chile has also instituted the most successful debt-for-equity program among third world debtors, which has helped it convert nearly \$1.5 billion of some \$19 billion in foreign obligations to investments since mid 1985. (Because Chile has continued to take on new debt, the net effect of the conversions has been to hold total debt constant, rather than to reduce it.) The government is currently engaged in a drive to shed many state owned enterprises and maintain its low fiscal deficit. Nevertheless, the very openness of the economy renders it vulnerable to external forces: Chile relies on foreign markets for its exports and the country's low, but improving, rate of domestic savings makes it dependent on external finance for development.* [REDACTED]

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