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Chile Again Tries Gradual Stabilization

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Chile Again Tries Gradual Stabilization

Introduction

For the second time within a decade, Chile is embarked upon a broad stabilization program designed to terminate inflation, to stabilize the external value of the currency, to rectify structural distortions from past inflationary periods, and to increase the pace of sound economic expansion. This program has been underway since President Eduardo Frei Montalva took office in late 1964. As in 1955, the Chilean Government chose to assault inflation gradually rather than via a "shock treatment." Since the relative efficacy of the two approaches to inflation are frequently the topic of debate, the current Chilean experience with gradualism is an important case-in-progress.

Advocates of the "shock treatment" for inflationary ills maintain that this approach is best because it permits the authorities to take steps necessary to reestablish monetary equilibrium and to lay the foundation for future progress while the need for strong remedial action is both clear and acceptable to the public. They point out that the alternative gradual approach is bound to be ineffective because, long before stabilization is achieved, the public will grow tired of austerity and it will be difficult to sustain anti-inflationary policy momentum in the face of increasing political pressures for release from monetary and other constraints. The "gradualists" retort that it is in fact virtually impossible to impose "instant stabilization". They argue

that such a course involves socially intolerable strains and stresses in the form of interrupted growth, unemployment and other sacrifices imposed on the working man, especially regarding wage adjustments. They claim that gradual stabilization allows sufficient time for overcoming distortions while spreading the burden of adjustment in a socially tolerable manner.

The current consensus among economists concerned with development in the poorer countries is, clearly, that monetary stability is a vital prerequisite to progress. Hence, Chile's elaborate and, thus far at least, sustained stabilization effort is being observed with interest. This is especially true in view of the inconclusive results of the program initiated in the crisis year of 1955, and of the continuing debate as to the optimum length of stabilization programs.

Historical Background

While Chile suffered from inflation since the 1870's, it was not until 1955 that this process threatened to get completely out of hand. There was advance warning in that the annual rate of price increase was rising over the previous two decades, but no effective counteraction was taken. Then the cost of living increased by 56 per cent in 1953, by 71 per cent in 1954 and by 85 per cent in 1955. ^{1/}

^{1/} Schott, Francis H., "Inflation and Stabilization Efforts in Chile, 1953-1958," Inter-American Economic Affairs, Winter 1959, p. 4.

Expanding budget deficits and increasing internecine economic strife among contending elements of Chilean society were exacerbating factors during this period. Toward the end of 1955 it was obvious that only severe measures would be sufficient to avoid total financial and, perhaps, social catastrophe. The Chilean Government then set about implementing a full-scale stabilization program, with the help of the Klein-Saks mission of U. S. consultants.

In view of unavoidable wage adjustments, it was soon decided that only gradual stabilization would be acceptable, and the program proceeded on that basis. Remedial action was directed toward the fiscal situation and public administration, credit policy, wage regulations, prices and subsidies, and the exchange system.^{2/} A major investment program for the expansion of copper-producing capacity was implemented, the Export-Import Bank granted substantial credits to the Chilean steel and nitrate industries, and the International Monetary Fund provided stand-by assistance. Considerable success was achieved in moderating price increases in 1956 and 1957. However, it proved difficult to balance the government's budget, despite a substantial increase in revenues. Declining copper prices beginning in 1957 slowed the rise of revenues and intensified the fiscal difficulties. Inflationary pressures increased in 1958, when the rate of price

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^{2/} Ibid.

It is against this background that Chile is pursuing renewed efforts to achieve stabilization, along with the broader aims of the socioeconomic program of Christian Democracy. ^{1/}

The Current Stabilization Program in Outline

Chile's present stabilization program consists of coordinated policy measures affecting taxation, public spending, wages and prices, money and credit, and the exchange system.

On the fiscal side, the Government implemented tax reforms to increase revenues and attempted to restrain spending so as to reduce the budget deficit and to minimize the necessity for potentially inflationary financing. The tax reform involved both adjustment of tax obligations and improvements in collection procedures. The Government placed increased reliance upon taxes on income and property and decreased its dependence upon levies on foreign trade. Income tax rates were made more progressive, and income tax liabilities were made adjustable through a link to the official consumer price index. A new tax on imputed income on net wealth was also introduced.

On the wage and price front, the Government attempted to employ a wage policy involving annual raises limited to the increase in productivity plus the official cost-of-living increase for the preceding year.

^{1/} The Frei government is seeking a redistribution of income toward the agricultural sector and toward the poorer classes in general.

This contrasts with more liberal increases formerly obtained through relatively unrestricted collective bargaining. In addition, the Government set price controls on items making up the basic market basket for the average Chilean, in order to reinforce the struggle for price stability.

With respect to monetary policy, the authorities thoroughly reviewed instruments and their employment. This resulted in some simplifications and more emphasis upon the productive use of credit. Commercial banks' operations were restrained by new credit control policies, including higher legal reserve requirements and tighter rules on the extension of Central Bank assistance to meet banks' legal reserve deficiencies. In addition, the selective credit mechanism was overhauled and made more restrictive.

The Central Bank adopted the policy of attempting to limit the annual increase in credit to a level consistent with the price targets. The objective was to use monetary policy both to restrict the growth in the money supply and, at the same time, to permit some elasticity in accordance with the aim of gradual, programmed stabilization, so as to reduce inflation without disrupting real economic expansion with overly tight credit.

Shortly after the Frei administration took office, monthly adjustments of the exchange rate were instituted, as opposed to the previous less-frequent changes. But it was not until late in 1966 that a policy designed to reduce the external overvaluation of the escudo was introduced. Under this policy, the monthly adjustments in the

exchange rate began to exceed the month-to-month increases in the cost-of-living index.

These policies are being applied in such a way as to bring about a gradual deceleration of price increase over a four-year period. The stated goal was to hold the cost-of-living increases to a maximum of 25 per cent in 1965, 15 per cent in 1966 and 10 per cent in 1967, with price stability to be reached in 1968. At the same time, the Government hopes to bolster economic growth through a moderate redistribution of income that has the dual purposes of social equity and expansion of the market economy.

The Results

The data in Table I show that the cost of living rose by about 26 per cent in 1965, and by another 17 per cent in 1966. Since the average increase in 1962-64 was 37 per cent, this represents progress. It is also close to the announced goals.

However, the money supply increased by 65 per cent in 1965 (See Table I). In 1966, despite a major increase in total assets of the Central Bank, the rate of growth in money supply was only about half that of 1965, largely because of increased legal reserve requirements for banks, a rise in the demand for currency and coin relative to checking deposits, and a large increase in time and savings deposits. The growth in money supply, while low in comparison with 1965 was about the same as the average rate of increase of previous years.

There is some evidence to indicate a modification of the inflationary psychology of the Chilean public. Table I shows a tendency for a gradual reduction in the velocity of money, from 13.2 in 1963 to a relatively low 11.0 in 1965. However, it is too early to conclude that the rate of turnover of money will continue to decrease, or that the limited progress made toward the eradication of the inflationary mentality will be extended.

The expansion of credit extended to the private sector by the central and commercial banks slowed in both 1965 and 1966. (See Table II). The annual percentage increases in these two years were about equal to the respective rises in cost-of-living, plus growth in real product.

Moreover, in 1966, there was a resumption of the real growth of time and savings deposits after three years of stagnation. (See Table III). In part, this increase was due to the introduction of a policy of periodic readjustment of the value of savings deposits in the State Bank in accordance with changes in the cost-of-living. The State Bank was also encouraged to seek such deposits by a reduction in marginal reserve requirements for time deposits. This is an indication that the public can be persuaded to save if it is afforded some protection against inflationary erosion of the value of the savings. In the past, the Government has not permitted the banks to pay (and charge) interest rates that would offer an inducement to save. In real terms, interest rates have been negative. While the introduction of readjustable accounts was a salutary short-run measure, it remains unclear whether the Government

intends to readjust Chile's interest rate structure. Perhaps it simply expects that existing rates will become attractive once inflation is brought under control.

On the other hand, the wage policy segment of the program has been rather ineffective. In the past two years, increases have regularly exceeded the guidelines. Pressure for wage increases in excess of the guidelines is continuing, both within and without the Chilean Government.

The fiscal performance in 1965 was marked by an upturn of the deficit in real terms, following a decline in the last two years before the inception of the stabilization program. However, the ratio of the deficit to total expenditures, which was declining in 1963 and 1964, declined further in 1965. (See Table IV). In current terms, expenditures rose 57 per cent and revenues increased 60 per cent in 1965. Wage increases for public sector employees, payments to inefficient and subsidized public enterprises, and stepped-up public investment mainly account for the rise in expenditures. The deficit was financed, in part, by U. S. program loan assistance and by the Central Bank, as in years past.

While complete data are not yet available, it is known that there was substantial progress toward fiscal balance in 1966. The deficit, in real terms, may have been reduced, and there was apparently little net resort to Central Bank financing. The spectacular rise in copper prices played a leading part in these results, since it meant a large increase in Government revenues.

The first two years of the stabilization effort coincided with an upsurge in production. Chilean gross national product, in real terms, grew by 7.3 per cent from 1964 to 1965. (See Table V). This means about a 5 per cent increase in real income per capita, a substantial advance for a Latin American country. Since 1957, growth in real gross national product approached the 1965 figure only in two other years. Provisional GNP data for 1966 indicate a rate of growth of 7.5 per cent. To a considerable extent, this growth was due to a favorable world market for copper, as prosperity spread from the copper industry to other sectors. This means that Chile has been experiencing its most sustained economic expansion in the past decade. As can be seen from Table V, the prosperous years 1960 and 1962 were followed by only rather modest GNP increases in 1961 and 1963, respectively.

Not only has Chile experienced substantial economic expansion since 1964, but its external accounts have also improved. Exports climbed from \$589 million in 1964 to \$685 million in 1965, and to an estimated \$930 million in 1966, (See Table VI) with the increase in the latter year being due principally to the rise in copper prices (See Table VII). Imports rose slightly between 1964 and 1965 from \$623 million to \$627 million, but they increased rapidly in 1966 to an estimated \$740 million. The merchandise trade balance improved from a deficit of \$32 million in 1964 to a surplus of \$60 million in 1965, and to an estimated \$190 million surplus in 1966. This was reflected in gains in gold and foreign exchange reserves of \$40 million in 1965. (See Table VIII). Provisional data indicate that this improvement was exceeded in 1966.

Higher receipts from copper exports combined with a continued high level of receipts from foreign aid to build up Chile's badly depleted reserves. Chile also benefited from a debt rescheduling, which postponed 70 per cent of the external debt payments due in 1965-66. Copper prices have receded somewhat, but in the meantime Chile has concluded agreements giving the Government an interest (in one case a majority) in the major foreign copper mining firms, and providing for investments that will give copper production a big boost. The Government hopes that in the long run this will sustain export levels and ease the relative weight of the external debt burden. If realized, this will make it possible for the country to pursue an accelerated program of economic development with less external assistance.

Until rather recently, Chilean exchange rate policy favored continued overvaluation of the escudo, creating a tendency to over-import. Among the multiple rates controlled by the Central Bank, the most important one was the futures rate. This rate was depreciated frequently but, at least in 1965, not to the same extent as the cost of living was increasing. While this practice may have helped to slow inflation somewhat by insulating the internal economy from potentially higher escudo prices for imports, it also fueled the demand for imports and impeded marginal exports. Efforts were made to restrain import demand by high tariffs, surcharges and prior import deposits.

At times in 1966, the depreciation of the escudo in the foreign exchange futures market outran the domestic increase in prices. However, the pattern varied. On balance, some progress was made toward reducing

the degree of overvaluation in the last three months of the year.

Late in 1966, President Frei announced that Chile would forego program-type assistance from the U. S. Agency for International Development and from the International Monetary Fund during 1967. He added that he might seek resumption of this aid if copper prices declined below a level deemed necessary to ensure both an improvement of the foreign reserve situation and the receipt of revenues from copper taxes adequate to finance the Government's investment program. At the same time, Chile notified its "Paris Club" foreign creditors that it would not require another rollover of debt.

The decision to emphasize self-help and progress toward economic independence in 1967 involved a determination to moderate the growth of the country's external debt. But, if the decline in world copper prices is extended much below recent levels for any prolonged period, it is possible that Chile may decide to request a renewal of external program-type assistance.

The Prospects

It appears that Chile may find it more difficult to achieve the price change goal for 1967 than those of 1965 and 1966. Already, the cost of living is up 11.9 per cent in the first 5 months of 1967, exceeding the original target for the entire year. Copper prices have receded, making it less likely that last year's fiscal performance can be repeated in 1967. Moreover, the Christian Democrats were dealt a setback in recent municipal elections. While President Frei has not

lost any voting strength in the Chilean Congress, he may now feel it necessary to give more heed to the desires of opposition parties. The latter are less devoted to the concept of monetary stability, when it implies budgetary and wage restraints.

A continued slow decline in the rate of growth of credits to the private sector is likely during 1967. However, there will be continuing pressure for larger wage raises, despite the major gains of workers (in real terms) over the past two and one-half years.

Overall, the gradual stabilization program has been a qualified success up to early 1967. President Frei has succeeded in mobilizing and maintaining public support for stabilization to an extent that is surprising in view of the country's long inflationary history. However, the task has been made much easier by the large windfall obtained from the rise in the price of copper. This permitted Chile to raise incomes, dispense with U. S. balance-of-payments assistance, and accumulate reserves. The hardest test of the government's ability to adhere to its program still lies ahead, as the price of copper eases and balance-of-payments pressures become more severe.

Table I

Chile: Cost of Living, Money Supply, Velocity

	<u>1957</u>	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
<u>Cost-of-Living</u> ^{1/} Index end-December	75	100	133	141	154	196	285	396	498	583
Increase in C.O.L. over previous year- end (in %)	-	33.3	33.0	6.0	9.2	27.3	45.4	38.9	25.8	17.1
<u>Money Supply</u> ^{2/}	165	222	294	384	432	556	747	1,129	1,867	2,594
				(millions of escudos; end-of-period)						
Increase in money supply over previous year-end (in %)	-	35	32	31	13	29	34	51	65	39
<u>Velocity of Money</u> ^{3/}	13.8	13.2	14.1	12.7	12.6	11.9	13.2	13.2	11.0	-

1/ Source: IMF, International Financial Statistics, April, 1967, p. 33; June, 1963, p. 35.

2/ Source: IMF, International Financial Statistics, April, 1967, pp. 76-77; January, 1964, p. 74.

3/ GNP in current escudos divided by money supply. Since money supply figures are end-year data, velocity is probably understated.

Table II

Banking System Credit to Private Sector
1957-1966
(millions of escudos; end-of-period)

	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
1) Central Bank claims on private sector	117	117	54	58	78	89	103	155	193	244
2) Commercial Banks claims on private sector	177	226	398	467	586	766	976	1,370	1,885	2,440
3) Total banking claims on private sector	-	-	452	525	664	855	1,079	1,525	2,078	2,674
Percentage Increase over previous year	-	-	-	24	26	29	26	41	36	29

Source: IMF, International Financial Statistics, April 1967, pp. 76-77, January 1964, p. 74.

1/ Not available on comparable basis.

Table III

Chile-Time and Savings Deposits-1957 - 1966
(millions of escudos; end-of-period)

	<u>1957</u>	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
Time, Savings Deposits	41	57	133	168	206	326	380	531	657	1,033
Per Cent Increase over previous year	-	39	133	26	23	58	17	40	24	57
Time, Savings Deposits in escudos of 1958	55	57	100	119	134	166	133	134	132	177
Per Cent Increase over previous year in escudos of 1958 (in real terms)	-	4	75	19	13	24	-20	-	-1	34

Source: IMF, International Financial Statistics, April 1967, pp. 76-77, January 1964, p. 74.

Note: Since statistical deflation is imprecise, deflated figures in this and other tables should be taken only as indicators of general trends.

Table IV

Chile-Fiscal Development-1957-1965
(millions of escudos)

	<u>1957</u>	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	1958- 1965 AVG.
Budget Deficit in current escudos	-32	-44	-68	-132	-146	-229	-236	-307	-425	
Percentage change over previous year	-	38	55	94	11	57	3	30	38	41
Revenue	308	376	570	708	785	957	1,354	2,038	3,254	
Expenditures	340	420	638	839	931	1,186	1,590	2,346	3,678	
Budget Deficit as a percentage of total expenditures	9	10	.11	16	16	19	15	13	12	
Budget Deficit as a percentage of GNP in current terms	1.4	1.5	1.6	2.7	2.7	3.5	2.4	2.1	2.1	
Budget Deficit in 1958 escudos	-41	-44	-49	-85	-87	-121	-86	-77	-83	
Per Cent Change in Budget Deficit in 1958 escudos over preceding year	-	7	11	73	2	39	-29	-11	8	

Source: IMF, International Financial Statistics, April 1957, p. 78.

Table V

Chile-Gross National Product, 1957-1966
(millions of escudos) ^{1/}

	<u>1957</u>	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966^e</u>	<u>1957- 1966 AVG.</u>
GNP in current terms	2,274	2,929	4,145	4,895	5,457	6,595	9,827	14,882	20,435		
DNP in Escudos of 1958	2,878	2,929	2,982	3,158	3,268	3,471	3,586	3,721	3,991		
Percentage increase over preceding year in real terms	-	1.8	1.8	5.9	3.5	6.2	3.3	3.8	7.3	7.5	4.5
GNP per capita in Escudos of 1958	403	400	398	411	416	432	436	444	466		
Percentage increase over preceding year in real terms	-	-1	-1	3.3	1.2	3.8	1.0	1.8	5.0	5.4	2.2

Source: IMF, International Financial Statistics, April 1967, pp. 76-77; November 1962, p. 80.

^{1/} The Escudo, equal to 1,000 Chilean pesos, was established on January 1, 1960.

Table VI

Chile-Balance of Payments-1958-1966
(in millions of U. S. dollars)

	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u> ^e
A. Current Account									
Merchandise Exports	362	450	479	443	482	491	589	686	930
Merchandise Imports	427	426	558	627	602	577	623	627	740
Trade Balance <u>1/</u>	-63	25	-78	-182	-119	-84	-32	60	190
Net Services	-44	-68	-100	-120	-108	-125	-113	-111	-
Net Current Account	-107	-43	-178	-302	-227	-209	-145	-51	-
B. Net Transfers	30	36	47	24	15	6	10	9	-
C. Capital Account and Monetary gold									
Direct Investment	47	54	29	52	36	-30	-9	-7	-
Other Private Long-Term Investment	14	3	15	56	58	42	72	8	-
Other Private Short-Term Investment	-18	16	10	24	-57	-31	-9	-55	-
Central Government Capital	-8	-29	-13	44	88	122	92	147	-
Net non-monetary Capital Account	35	44	41	176	118	103	146	93	-
Net Commercial bank foreign assets	-6	27	-1	15	49	-	-5	-16	-
Net Central Bank foreign assets and gold	28	-56	45	111	20	30	-20	-40	-
Net Monetary Sector	22	-29	44	126	69	30	-25	-56	-
Errors and Omissions	20	-8	46	-23	26	70	14	4	-

1/ Includes non-monetary gold.

Source: IMF, Balance of Payments Yearbook, Vols. 15, 17, 18.

Table VII

Chile-Copper Prices, 1959-1967 ^{1/}
(U. S. cents per pound, annual average)

	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u> ^{2/}
Copper Price	29.68	30.70	28.69	29.23	29.26	43.84	58.72	69.22	46.93

^{1/} Wholesale price quotations on the London Market.

^{2/} May average.

Source: IMF, International Financial Statistics, July 1967, p. 27.

Table VIII

Chile-Changes in Cost-of-Living and Exchange Rate

	<u>1/</u> Dec. 1965	Mar. 1966	June 1966	Sept. 1966	Dec. 1966	Mar. 1967	May 1967	1965 over 1964	1966 over 1965
Cumulative Percentage Increase in Cost-of-Living Index over December 1964	25.7	35.8	41.9/	52.3	47.1	58.1	64.6		
Cumulative Percentage Increase in Exchange Rate over December 1964	14.2	20.6	29.0	34.5	41.0	49.0	55.8		
Cumulative Excess of Percentage Increase In Cost-of-Living over Percentage Increase in Exchange Rate (In Percentage Points)	11.5	15.2	12.9	17.8	6.1	9.1	8.8	11.5	-5.4

1/ Increases are over December, 1964.