CHAPTER 6

Debt Crisis and Recovery, 1982–89

In 1982, the external shocks that struck Chile—the cutoff of bank loans, the rise of international interest rates, and falling terms of trade—and the "automatic domestic adjustment" process carried out implied a 14 percent plunge in GDP, the largest drop among Latin American countries in that year. The Chilean economy began to recover in 1984. However, only in 1989 did GDP per capita recover to its precrisis level.

In the early stages, the adjustment followed a rigorous orthodox approach in continuity with previous years. Aggregate demand was curtailed sharply through an automatic adjustment associated with losses in international reserves; most public policies were kept "neutral." Subsequently, due to the severity of the crisis, authorities moved toward more pragmatic policies. In order to ease the external adjustment, tariffs were raised in combination with strong real exchange rate depreciation. Private debt was—directly or indirectly—"nationalized," with the public sector share rising from one-third in 1981 to 86 percent of total debt in 1987. Interest payments were punctually served.

In 1987–88, Chile experienced three positive external shocks—a sharp rise of the price of copper, an agreement with creditor banks to postpone half of the interest payments from 1988 to 1991–93, and other foreign exchange savings resulting from debt swaps. As a result, the economy benefited from the relaxation of binding external restrictions, which allowed a significant aggregate demand expansion in 1988–89. In the productive sector, output was rising, essentially through the use of idle capacity. Therefore, effective growth between the previous peak, in 1981, and the new peak in 1989 averaged only 2.7 percent per year.

The chapter begins by summarizing the causes, uses, and effects of foreign debt accumulation in the period of large positive net transfers in 1977–81; then it focuses on the large negative net transfers in 1982–89.

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An analysis of the macroeconomic adjustments in 1982–89 is developed, including an assessment of the relative importance of (1) external shocks, (2) demand-reducing policies, and (3) supply- and demand-switching policies. This is followed by a discussion of debt management after the crisis and a summary of the more pragmatic changes in policy design forced by the crisis. The final section focuses on the macroeconomic performance of the period in terms of GDP growth, investment, and sustainability.

The Debt Crisis

Accumulation of Imbalances in 1977–81

As was discussed in chapter 5, Chile accumulated a large foreign debt in 1977–81.[1] Borrowing was principally by private Chilean firms from foreign banks. The loans carried no guarantee from the Chilean government. Thus, there was major privatization of the sources and uses of debt (see table 6.1).

Until late 1981, net inflows exceeded the absorptive capacity of the domestic economy. Therefore, international reserves accumulated and exerted pressure for real exchange rate appreciation and import expansion. Since the growth of imports outran that of exports, the deficit in the trade balance underwent persistent and substantial increases. The external deficit was led by huge capital inflows, which stimulated aggregate demand and allowed exchange rate appreciation and further trade liberalization. This, in turn, encouraged the increase in imports. A proof of this causality is the accumulation of international reserves during most of that period (see chap. 5 and Ffrench-Davis 1982).

The growing capital inflows, which originated in the fast-rising international supply, were encouraged by the steady capital account liberalization in Chile. Furthermore, a very lax and passive prudential supervision (Held and Jiménez 2001), in combination with a relaxation in the sources of external funds, increasingly eased transfers of oil surpluses from bank lenders to the emerging markets (Valdés-Prieto 1989). The oversupply of external loans, in turn, financed and stimulated higher domestic expenditures, provoking a significant fall in national savings (Zahler 1988). Thus, foreign savings crowded out national savings as a

1. For more detailed analyses of domestic financial reforms in Chile, see Arellano 1983; Eyzaguirre 1988; Fontaine 1989; and Zahler 1988. A comparative analysis of Latin American cases in the 1970s and early 1980s is presented in Ffrench-Davis 1983b. The 1980s are examined in Devlin 1989; Feinberg and Ffrench-Davis 1988; Ffrench-Davis 2000, chap. 4; and Griffith-Jones and Rodríguez 1992.

TABLE 6.1. Foreign Debt of Chile, 1975–89 (in U.S.$ millions and percentages of total)

	Total (1)[a]	Private with Guarantee (2)[b]	Public and Publicly Guaranteed Amount (3)	Public and Publicly Guaranteed % (4)[c]	Private without Guarantee Amount (5)	Private without Guarantee % (6)[c]	Capitalized Debt (7)[d]	Total Including Capitalized Debt (1) + (7) (8)[e]
1975	5,453	21	4,667	85.6	786	14.4		5,453
1976	5,392	30	4,434	82.2	958	17.8		5,392
1977	5,763	46	4,479	77.7	1,284	22.3		5,763
1978	7,153	48	5,198	72.7	1,955	27.3		7,153
1979	8,790	76	5,369	61.1	3,421	38.9		8,790
1980	11,325	72	5,304	46.8	6,021	53.2		11,325
1981	15,700	69	5,623	35.8	10,077	64.2		15,700
1982	17,263	62	6,770	39.2	10,493	60.8		17,263
1983	18,133	1,815	10,497	57.9	7,636	42.1		18,133
1984	19,746	2,130	13,212	66.9	6,534	33.1	11	19,757
1985	20,607	2,348	15,242	74.0	5,365	26.0	85	20,690
1986	20,898	3,408	17,160	82.1	3,738	17.9	355	21,236
1987	20,722	3,276	17,894	86.4	2,828	13.6	1,187	21,844
1988	19,012	2,829	16,083	84.6	2,929	15.4	2,112	20,965
1989	17,569	2,120	13,568	72.2	4,001	22.8	3,436	20,629

Source: Central Bank of Chile, *External Debt of Chile*, 1990. Figures refer to end-of-year disbursed outstanding debt.

[a]Total including IMF and debt payable in domestic currency and excluding short-term trade credit to nonbank debtors; the latter amounted to U.S.$800 million in 1985 and U.S.$1.1 billion in 1989.

[b]Chilean private debt publicly guaranteed.

[c]Columns 4 and 6 are percentages of column 1.

[d]Face value of debt capitalized through Decree 600 and debt-equity operations through Chapter XIX.

[e]Column 1 plus 100 percent of debt capitalized through Decree 600 plus the redenomination value of capitalized debt through Chapter XIX: averages of 93 percent in 1985–87, 89 percent in 1988, and 84 percent in 1989. See table 7.5.

result of the nature and interaction of the financial and trade reforms carried out in Chile (see chaps. 3 and 5), the overoptimistic environment generated, and the fact that most flows were financial, with a low share of FDI.

Therefore, the national economy became increasingly dependent on massive capital inflows. This was of little concern in official circles, however. It was assumed that a currency crisis was impossible because the debt was mainly private, and thus would be efficiently used (Robichek 1981, 171–72),[2] and the fiscal budget was in surplus, with reserves exceeding the money supply.

2. It was supposed initially that no private loss would be taken over by the public sector. However, after the intervention and rescue of the Banco Osorno, a state guarantee on deposits in domestic currency was established in 1977 (Held and Jiménez 2001).

The foreign currency supplied by loans was used largely to finance an "excess" of imports of consumer and intermediate goods by the private sector (Ffrench-Davis and De Gregorio 1987), in a framework of low capital flight (Arellano and Ramos 1987) but depressed investment. In fact, about three-fourths of the net debt rise in 1977–82 was used to increase the import/GDP coefficient of the Chilean economy. The data suggest that, in net macroterms, none of the loans financed the expansion of productive capacity.[3] Excess imports crowded out domestic manufactures and investment in tradables, while the growing and unsustainable external gap made a future downward adjustment unavoidable.

It is interesting to highlight two contrasts, one positive and one negative, between Chile and other Latin American countries (LACs). On the one hand, capital flight was rather low in Chile, while in Argentina and Venezuela it was notably high (Frenkel 1983). On the other hand, the investment ratio was low in Chile, while Brazil and Colombia exhibited significant productive capital formation as a consequence of more efficient absorption of foreign resources (see Bacha 1983 and Perry and Junguito 1983).

The curtailment of foreign financing in 1982 coincided with notably high real international interest rates and a sizable fall in copper prices. Moreover, the Chilean economy had become particularly vulnerable to external shocks because the government had done away with most of the regulatory mechanisms that coped with external instability (instead relying on the automatism of the dollar standard or currency board) and because the private sector (consumers and figures) was overleveraged (Arellano 1983; Eyzaguirre 1988).

The external shocks, therefore, had an unusually large multiplier effect on the domestic economy. GDP fell by 14 percent in 1982, with manufacturing output falling by 21 percent. Expenditure reducing dominated expenditure switching policies (as will be documented later).

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3. The fixed investment rate in 1977 constant prices was 20.2 percent in the 1960s. It dropped to 15.5 percent in 1975–81 and to 15.4 percent in 1982–89. This decline can be partly explained by the trade-policy-induced fall in the domestic real prices of imported consumer goods and the role played by the financial system in diverting resources from savings to consumption in a context of lax prudential supervision. See chapter 3; Arellano 1983; and Zahler 1988. But beyond the weaknesses of supervision an important factor was the euphoric attitude of people in the highest income brackets. As a consequence, there appears to have been anticipation of consumption based on overoptimistic expectations of growth capacity. Therefore, there was an intertemporal destabilizing adjustment. See Ffrench-Davis and Reisen 1998 for a similar destabilizing adjustment in Argentina and Mexico in the first half of the 1990s.

Recession in the 1980s

Chile suffered three severe negative external shocks in the early 1980s, which led to a sharp drop in the expenditure capacity of the economy.

The strongest shock was related to gross capital flows. After climbing to 19 percent of GDP, the use of foreign savings fell to one-half of that figure in 1982 and to one-fourth in 1983 (see table 6.2).[4] Clearly, the figure recorded in 1981 reflected a gross policy mistake, which allowed excessive indebtedness. Since 1977, the Chilean economy had been adjusting (in both the productive sector and expenditures) to a unsustainable level of capital inflows. Consequently, aggregate demand was exceeding domestic output, by unsustainable amounts, and even without an international debt crisis a major readjustment would have been needed in the near future. The fact that in the second half of 1981—long before the Mexican crisis of August 1982—GDP had begun to fall (Marcel and Meller 1983, table 1) is clear evidence of this.

Adjustment was unavoidable, no matter how well Chile might have managed relations with creditor banks after 1982. The best outcome certainly would have been a zero net transfer, and even that would have implied a huge decline in net capital inflows compared to those of 1977–81.

A second shock was the increase in interest payments that had been associated with growing indebtedness and an impressive jump in the financial cost of foreign debt since late 1979. The third shock was the decline in the terms of trade, which was led by the copper price drop.

Associated with these three external shocks, a serious domestic recession occurred in 1982. In the external sector, the shocks caused sharp reserve losses. Subsequently, an "automatic adjustment," set in motion by the contraction in the supply of foreign currency, exacerbated the reduction in domestic liquidity and aggregate demand. This resulted in a 17.2 percent decline in GDP per capita in 1982–83 and a decrease in investment. Therefore, a large gap soon arose between potential and actual GDP. The productive frontier expansion, in turn, lost speed because of the lower investment ratio.

The ideal adjustment in a perfectly flexible economy would eliminate excess aggregate demand without generating a gap between actual and potential GDP. In an economy with initial underutilization of capacity in the production of tradables, adjustment with an appropriate dose of

4. The figures used in this chapter are based on official national accounts, calculated in 1977 relative prices. Naturally, the external sector weight (and its associated shocks) depends on the base year. In 1981 prices, it decreases; in 1976–78 and 1986 prices, it increases.

switching policies could even achieve an increase in resource utilization and output. But, in an economy with price inflexibility, imperfect factor mobility, and limited or confusing information, neutral demand-reducing policies (i.e., policies that affect all expenditure components) can cause a significant drop in output because the demand for both tradables and nontradables diminishes. In the real world, adjustment processes usually involve a drop in output. This causes a lower rate of utilization of installed capacity and subsequently a fall in capacity formation.

Selective policies that facilitate switches in the composition of output and expenditure can dampen output-reducing effects. A good combination of expenditure-reducing and switching policies would tend to allow an outcome closer to a constant rate of utilization of potential GDP (see Ffrench-Davis and Marfán 1989). In fact, if an excess of expenditure prevails, as in 1981, then it is urgent to reduce aggregate demand. However, this can be done in combination with switching policies that are oriented toward reducing the demand for tradables and promoting the supply of exports and domestic investment (see Ffrench-Davis and Reisen 1998; and Ffrench-Davis 2000, chap. 6).

Here follows a brief account of estimates of the external shocks and the paths taken by GDP, aggregate demand, exports, and imports during 1980–89. The purpose is to provide rough estimates of two components of the economic costs of recessive adjustment: underutilization of installed capacity and slackened creation of new capacity.

All variables fluctuated widely in this period, as is shown in table 6.2. Economic activity peaked in 1981. The actual GDP of 1981 is taken as a close indicator of productive capacity as of that year (see chap. 1). In table 6.2, all figures are expressed in per capita terms and as percentages of GDP in 1981. Comparing any figure in a given line to its value in 1981 indicates the change with respect to a situation of constant GDP per capita and constant shares of all other variables in the table. For instance, the 1987 figure for fixed capital formation indicates a fall from 19.5 in 1981 to 15.5. As a share of 1987 GDP (the traditional indicator), the decline was from 19.5 to 16.4 percent. The latter figure, however, does not consider the investment behavior per worker or inhabitant, as is captured in table 6.2.

Actual GDP, in 1983–87, averaged 88.4 percent of 1981 GDP. As in the meantime potential output grew by some points (see chap. 1 and Marfán 1992), the gap between actual and potential GDP was even wider: 14.4 points per annum (table 6.2, lines 1a and1b). Exclusively, only in 1989 did actual and potential GDP converge. The significant underutilization shows that demand-reducing policies had strong negative effects on output, while switching policies (exchange rate and trade policies, the selective fiscal policy, etc.) were weak. This shortcoming was reinforced

TABLE 6.2. Production, Consumption, Investment, and External Shocks per Capita, 1980–89 (per capita variables in 1977 pesos as a share of 1981 actual GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	Average 1983–87	Average 1988–89
1. (a) Actual GDP	96.3	100.0	84.6	82.8	86.7	87.4	90.8	94.4	99.7	107.8	88.4	103.7
(b) Potential GDP	97.1	99.0	102.0	102.7	101.2	102.6	103.4	104.3	105.9	107.8	102.8	106.8
2. Domestic expenditure	102.8	112.9	84.5	79.4	84.7	81.8	84.8	89.5	95.8	105.7	84.1	100.8
3. Consumption	79.7	85.3	75.0	71.7	71.5	69.7	71.1	72.6	77.8	82.2	71.3	80.0
4. Fixed investment	17.0	19.5	12.7	10.7	11.4	12.9	13.6	15.5	16.9	20.1	12.8	18.5
5. Domestic savings	16.5	14.7	9.6	11.1	15.2	17.7	19.7	21.8	21.9	25.6	17.1	23.7
6. Nonfinancial current account	−6.5	−12.9	0.2	3.4	1.9	5.5	6.0	4.9	3.8	2.1	4.4	3.0
(a) Exports	22.8	20.4	21.1	20.9	22.0	23.1	25.0	26.7	27.9	31.7	23.5	29.8
(b) Imports	29.3	33.3	20.9	17.5	20.0	17.6	18.9	21.8	24.0	29.6	19.2	26.8
7. Terms of trade effect	2.0	0.0	−2.1	−1.1	−2.8	−3.4	−3.0	−1.6	1.5	0.9	−2.4	1.2
8. Net interest and profits paid	−3.4	−5.1	−6.7	−6.6	−7.3	−7.3	−7.2	−6.0	−6.4	−6.2	−6.9	−6.3
9. Current account deficit[a]	8.2	18.5	9.3	4.7	8.5	6.0	4.4	2.7	1.1	2.4	5.2	1.8
(a) Capital flows[a]	13.1	18.7	4.8	2.6	9.3	5.6	3.6	2.8	3.2	3.5	4.8	3.3
(b) Change in reserves[b]	4.9	0.3	−4.5	−2.1	0.1	−0.4	−0.8	0.1	2.0	1.1	−0.6	1.6

Source: Author's calculations based on official figures of the Central Bank of Chile and chapter 1.

[a]Unrequited transfers included. Figures based on balance of payments data, which can differ from those of the national accounts.

[b]Figures based on balance of payments data, which can differ from those of the national accounts.

by the structural inflexibility in aggregate demand and supply, given the strength first of positive and then of negative external shocks.[5]

The three external shocks are measured in lines 7, 8, and 9 of the table. Line 9 shows the net use of foreign capital. In the short run, Chile could use its international reserves. That is the reason why this shock appears to be not as intense in 1982 as the cutoff in external financing. The Central Bank lost reserves by 5 percent of GDP to compensate for the foreign capital shortage.

The reserve losses, with a fixed exchange rate and passive monetary policy at the outset of the crisis, gave rise to the sharp reduction in domestic expenditure (line 2) on both consumption and investment. They were transmitted to the external sector (line 6), reducing imports and increasing exportable supply. To reduce the external gap, the indirect tool of an extremely large reduction in aggregate demand was used as the main policy variable.

The 12 percent drop in effective GDP in the quinquennium 1983–87 with respect to 1981 is the "static" output-reducing effect of the combination of external shocks and weak switching policies. In the "dynamic" dimension, investment per capita had fallen 45 percent by 1983 (line 4), reducing both potential GDP growth and the capacity to restructure the composition of supply and demand, which is directly associated with the level of new capital formation. Thus, the low investment rate reduced the possibility of a constructive adjustment of the economy. Furthermore, it was a crucial factor in the poor behavior of real wages in the 1970s and 1980s (see chap. 9).

The other dynamic effect is the impact of the output gap on the creation of new productive capacity. Actually, the drop in capital formation was significantly associated with the large gap between potential and effective GDP (Agosin 1998).

An "automatic adjustment" mechanism, as was used in 1982, relies heavily on the shock effects of demand-reducing policies. After a one-shot endogenous downward adjustment of domestic expenditure, as time goes by, some switching in demand and supply composition gradually takes place spontaneously. That reallocation was assisted additionally by an increase in tariffs and a series of sizable exchange rate devaluations within a crawling peg scheme (see table 6.3).[6]

Notwithstanding the delay and weakness of the switching, there was a gradual recovery of output and expenditure. This was greatly acceler-

5. When an economy has been oriented toward becoming more intensive in foreign inputs for a long time (as during the 1970s), it is not easy to reverse the trend without significant real costs.

6. In my view, the strong depreciation was a necessary element, but it was insufficient. The failure was in the lack of other selective switching policies.

ated by a sharp positive shock in the terms of trade in 1988–89 (line 7). However, by 1988, GDP per capita was still below the level achieved in 1981, while investment per capita was 13 percent lower. Only in 1989 did GDP per capita exceed its 1981 level. This was, in addition, the end of a cycle because macroeconomic overheating demanded a major new adjustment in late 1989 and 1990.

In the external sector, the automatic adjustment of 1982 was stronger and came sooner on imports, which are highly responsive to drops in domestic expenditure. Again, time allowed a change in the behavior of these two variables. Encouraged by large exchange rate depreciations, exports grew faster in the latter part of the period (table 6.2). In 1988, the quantum of exports of goods and services per capita was 22 percent above the peak level attained in 1980, while GDP was still below the peak of 1981.

It is interesting to measure the changes in exports and GDP between the peaks of economic activity in 1981 and 1989. Cumulative export growth per capita was significant: 55 percent and nine points as a share of GDP (six points if compared with 1980). However, the cumulative GDP growth was 7.8 percent. This implies that there was negative nonexport GDP growth (as shown in chap. 8).

The behavior of imports is also interesting. A strong recovery ensued following the spectacular drop recorded between 1981 and 1983 and the swings in 1984–86, which were linked to a minirecession experienced in 1985. Per capita imports grew by 57 percent between 1986 and 1989, a twofold increase over the per capita export growth in the triennium (see table 6.2, line 6). In the recovery following an adjustment such as the one carried out in 1982, it is normal for imports to grow faster than exports. Nevertheless, the difference in the rate of growth between both variables was excessive. The rapid increase was not evident in the trade balance at current prices due to a remarkable improvement in the terms of trade—led by the copper price—between 1987 and 1989.

Debt Management in 1982–89

In 1982, external debt was four times the export value and 71 percent of GDP. In the following years, there were five negotiation rounds with creditor banks framed by agreements with the International Monetary Fund (IMF) and the World Bank (three Structural Adjustment Loans [SAL] agreements).[7]

7. The five rounds—of 1983, 1984, 1985, 1987, and 1988—are discussed in Ffrench-Davis 1992. An analysis of the Latin American rounds is provided in Devlin and Ffrench-Davis 1995; and Ffrench-Davis 2000, chap. 4.

Liabilities with banks represented, as mentioned earlier, more than four-fifths of the country's total debt. The negotiations with banks were geared toward rescheduling maturities, maintaining short-term trade credit, and obtaining new loans to finance part of the interest payments. The remaining interest payments were financed with a trade surplus and net transfers from other creditors. Net transfers to bank creditors implied a negative flow of approximately 5 percent of GDP per annum in 1985–87.[8]

On the other hand, official creditors played a crucial role as net suppliers of funds. Multilateral institutions (the World Bank, IDB, and IMF) were the largest lenders. The World Bank and International Development Bank (IDB) with positive net transfers of U.S.$300 million per annum (table 6.3). This was a relatively large figure, as the net transfers from these two institutions to all of Latin America averaged only U.S.$1 billion annually in 1985–87 and turned negative in 1987.[9] As a consequence, private creditor banks reduced their participation to 65 percent of the total debt, while official creditors increased their share from 3 percent in 1982 to 30 percent in 1989. The small outstanding debt with IFIs climbed with an average growth rate of 32 percent per annum.

With regard to transfers by debtors, the state assumed responsibility for an overwhelming share of total debt. In 1987, the public sector share peaked at 86 percent of total debt, if the publicly guaranteed debt is included. This figure was 36 percent in 1981 (table 6.1). This debt "nationalization" was carried out in three ways. The main one was the growing indebtedness incurred by the Central Bank and other public organizations in order to provide foreign currency to cover interest commitments, both to public and private agents.[10] This took place in an environment in which voluntary loans to LDCs had disappeared. Second, the state granted ex post the public guarantee to the foreign debt of domestic banks, under pressure from creditors and some governments of developed nations. Third, the debt swap program mainly reduced private debt (see table 7.3).

Debt kept growing until 1985 (table 6.1, col. 1). Then it remained approximately constant through 1987 at around U.S.$20 billion, though

8. Additionally, creditor banks received prepayments in debt swaps, either in cash or in shares of Chilean firms.

9. The "favorable" treatment for Chile is discussed in Felix and Caskey 1990 and Ffrench-Davis 1992. In 1985–87, Chile received 30 percent of the net new loans of the IDB and the World Bank to Latin America, whereas it produced only 3 percent of the GDP of the region (at 1986 exchange rates). It must be recalled that the multilateral Chilean debt was very small in 1982.

10. Furthermore, the Central Bank granted other significant subsidies to private debtors. See Arellano and Marfán 1986, Ffrench-Davis and De Gregorio 1987, and Sanhueza 1999.

with changes in the shares of the various creditors. The drop in bank debt due to debt equity swaps was nearly offset by a rise in debt with multilateral institutions. It was only in 1988 that large swaps produced a net drop in the total debt. That year the Latin American debt also experienced a decrease, though to a lesser extent: only 2 percent in the region compared to 8 percent in Chile (ECLAC 1988).

The government initiated a two-tier system in May 1985 that allowed the prepayment of debt with creditor banks (this is discussed in detail in chap. 7). Later there were prepayment transactions, leading to a reduction of the debt stock and some direct writedowns (Elórtegui 1988; Fontaine 1988; Larraín 1988). The system was based on (1) the debt promissory notes (*pagarés de la deuda externa*) held by creditor banks, which sold them at an average discount of 40 percent of the face value in the international secondary market; and (2) the direct capitalization or conversion of external loans in equities. Until December 1989, U.S.$9 billion were swapped through the different channels, and there were "economic rents" (the difference between the face value and market price of the debt notes) of about U.S.$3.4 billion, which were captured by the agents involved in these operations.

The main benefit accruing from the equity swaps was the reduction of the debt stock; consequently, interest payment commitments were diminished. However, they also generated a series of other benefits and costs, the specifics of which depended on the particular features and management of the swaps. This is analyzed in chapter 7.

TABLE 6.3. Net Transfers Abroad by Creditor, 1983–89 (in U.S.$ millions)

	1983	1984	1985	1986	1987	1988	1989
Direct foreign investment[a]	51	−51	−56	−139	−57	−102	−5
Multilateral institutions[b]	167	248	349	266	253	109	33
Bilateral official[b]	−57	−101	−69	−60	−38	213	82
Suppliers[b]	−241	−154	−140	−7	131	−30	−19
Banks, MLT[b]	−178	−589	−718	−990	−988	−442	−791
Other MLT[c]	−21	−69	−24	−86	−100	−119	−104
Short term[d]	−834	906	0	198	−64	−423	405
Total	−1,113	190	−658	−818	−863	−794	−399

Source: Calculations based on data from the Central Bank of Chile.

[a]Net flows of foreign investment are disbursements minus net profits remitted after taxes; they exclude debt swaps, capitalization of credits, and reinvested profits.

[b]Net transfers from multilateral banks of medium- and long-term (MLT) foreign debt minus actual interest payments.

[c]Includes net interest payments to the IMF and medium- and long-term flows other than foreign debt.

[d]Includes credit lines, trade credit, other assets, interest receipts, and errors and omissions. It excludes the counterpart of debt swaps and flows for rolling debts.

TABLE 6.4. Amortizations, 1987–95 (in U.S.$ millions and annual averages)

Creditors	1987–88	1989–90	1991–93	1994–95
Multilateral institutions	95.8	230.0	338.2	441.8
Bilateral official	25.1	82.5	179.0	185.7
Banks and financial institutions	186.6	244.5	851.5	728.2
Suppliers and others	171.9	242.5	219.0	143.6
Total	479.3	799.2	1,587.7	1,499.2

Source: Central Bank of Chile, *External Debt of Chile*, 1989.

Note: This table includes the effects of debt reductions through debt-equity swaps. It excludes amortizations of future loans required to finance the external deficit after 1989. Therefore, it growingly underestimates amortizations from 1990 on.

After the negotiations with creditor banks in 1987–88, which had relaxed the debt service, the external environment faced by Chile improved notably. The price of copper rose sharply, as did other export prices (cellulose, fish meal, etc.). The terms of trade improvement together with the postponement of capital services for 1991–95 (see table 6.4) implied that the binding external constraint prevailing in 1982–87 had disappeared in 1988. These positive shocks led to a spectacular increase in the amount of foreign exchange available (ECLAC 1988), which allowed the full use of productive capacity and then the overheating of the economy in 1989.

More Pragmatism in Economic Policy

After the first years of adjustment, a more pragmatic macroeconomic policy, aimed at expanding nontraditional exports, increasing domestic savings, and strengthening the corporate and financial sector, was put into practice. There was recognition that there were failures in strategic areas such as the financial and export markets (Larraín and Vergara 2000).

When external funding became scarce, an increase in domestic savings (which in 1982 had faded to 2.1 percent of GDP) turned out to be essential to financing more investment. In order to encourage increased private savings, in 1984 a tax reform was implemented. Several measures were adopted to cope with the weakening of public finances.[11] These included setting wage increases for the public sector below the inflation rate and reductions in several categories of public spending, including social expenditure. As a result, the fiscal deficit improved

11. Weakening was caused by the cost to the Treasury of the 1981 social security reform as well as a depression in imports and economic activity.

from 3.5 percent of GDP to a balance in 1987 (Larraín 1991). Given the way in which this balancing was achieved, it had an indisputable regressive bias, as discussed in chapter 9.

With respect to private nonfinancial companies, since 1982 most of them had suffered the effects of the high interest rates, recession, and exchange rate devaluation on their foreign debt. This, together with rather opaque banking practices and a liberal regulatory framework, laid the foundation for an enormous financial crisis, which forced the government to intervene with several financial companies that were experiencing problems, including the two largest private banks.

The government reacted to the financial crisis by implementing an aid program for local debtors and banks (with an estimated cumulative cost of 35 percent of annual GDP), which included, among other measures, a preferential rate for dollar debts, loans at subsidized rates for the financial sector, and the Central Bank's purchase of the banks' nonperforming portfolios, with a commitment from the latter to repurchase them (Sanhueza 1999).

In the mid-1980s, a second round of privatization was carried out. This affected forty-six companies (including financial institutions that had experienced intervention in 1983 and traditional public firms), which were quickly transferred to the private sector (Devlin and Cominetti 1994; Hachette and Lüders 1992).

Among the changes that followed the debt crisis were reforms in trade and exchange rate policies. Some tariff protection was reintroduced, with an increase in the uniform rate from 10 to 35 percent, a 10 percent drawback to minor exports, and other measures discussed in chapter 8. The reshuffling of exchange rate policy was dramatic, with a return to a crawling peg, after bypassing the nominal peg for three years, and a totally flexible rate for a brief period. But the most novel intervention was a series of sharp devaluations that accumulated a real depreciation of 130 percent between 1982 and 1988. Policies were accommodated to the severe shortage of foreign currency in Chile (a more serious shortage than in the rest of the region, as was discussed in chap. 5). These devaluations allowed a better response to external conditions by encouraging exports and a recovery in the production of importables.

The Chilean banking crisis of 1981–86, which followed on the heels of a massive capital surge in the late 1970s, left in its wake a number of valuable lessons that were reflected in Chilean legislation (see Díaz-Alejandro 1985; Held and Jiménez 2001; Renstein and Rosende 2000; Valdés-Prieto 1992; and Aninat and Larraín 1996). Therefore, a deep financial reform was carried out, which was based on rigorous prudential supervision and strengthening of the regulating agency (the Superintendencia de Bancos). The elements of prudential supervision included

the continuous monitoring of the quality of bank assets; strict limits on banks' lending to related agents; automatic mechanisms to adjust banks' capital when its market value falls below thresholds set by regulators; and the authority to freeze bank operations, prevent banks in trouble from transferring funds to third parties, and restrict dividend payments by institutions not complying with capital requirements.

Debt and Economic Recovery

Chile fully serviced its debt and came to enjoy rather harmonious relations with its creditors, but the claim that it was able to both service its debt and grow cannot be sustained. That claim relies on the recovery recorded from 1984 on. However, it must be taken into account (1) that there was a huge GDP drop in 1982–83, which implies an artificially low base of comparison; (2) the sizable net transfers from multilateral institutions used to finance part of the payments to creditor banks; and (3) the high copper price that prevailed between 1987 and 1989. Notice that it took six years (up to 1987) for total GDP to overtake the 1981 level, while GDP per capita had to wait until 1989. Furthermore, disposable income was even lower than GDP per capita because of the negative external transfers and only in 1992 did the average wage surpass that of 1981.

The Chilean economy has been very unstable in past decades. In terms of output (GDP), in the 1980s Chile registered the worst drop in 1982 and the greatest expansion in 1989, compared to those of all other Latin American countries. Both changes (i.e., the fall and the expansion) were related to external shocks: deterioration in the terms of trade and foreign debt service, in the first case, and an unexpected improvement in the terms of trade in the second.

Apologetic versions of the economic policy implemented by the Pinochet regime emphasize the evolution of the Chilean economy after the fall, focusing particularly on the 10 percent increase in GDP in 1989. This is misleading for two reasons. In the first place, the greater the fall in economic activity the stronger the subsequent recovery can be. In assessing the results of economic policies, therefore, it is necessary to weigh the overall effects and not just one part of the results (i.e., solely the recovery) because this provides a biased view, particularly in an economy that has had so many ups and downs.

The second reason is that the great expansion of 1989 was not sustainable. It was based on transitory factors that allowed sharp GDP growth, and they could not avoid an overheating of the economy, causing negative effects on macroeconomic and macrosocial balances, which

actually required a demand-reducing adjustment in 1990. In fact, the modest investment rate allowed limited sustainable GDP growth of about 4 percent in 1988–89. In reality, the average growth rate in 1981–89 was rather small: only 2.7 percent per annum.

Production Trends and Productive Investment

Beyond short-term fluctuations, trends in GDP are determined by the intensity with which new productive capacity is created. This is related to investment and its productivity.

In the period covered by the Pinochet regime, the average increase of GDP was around 3 percent per year, including drops as deep as 17 percent in 1975 and 14 percent in 1982 and increases of 8 percent in 1977 and 1979 and 10 percent in 1989. The moderate increase of GDP in Chile was accompanied by a strong expansion of exports. The latter experienced a real increase of 10 percent per year between 1974 and 1989.

The main reason why economic growth has been so moderate since 1974 is that investment has been low. Average investment in the sixteen-year period under study was 15.6 percent of GDP. This figure is much lower than the 20.2 percent ratio recorded in the 1960s. This is why, notwithstanding changes in efficiency, productive capacity expanded considerably more in the 1960s: the annual rate was 4.6 percent.

In the 1980s, real wages experienced a significant drop: in 1989, wages were 8 percent lower than in 1981. Three factors can explain why. (1) GDP growth was low (GDP per capita rose barely 0.9 percent per year between 1981 and 1989), (2) a significant portion of production leaked out abroad to service the heavy foreign debt accumulated between 1976 and 1982, and (3) the Chilean economy became much more regressive (see chap. 9).

Low levels of investment were related to the fact that productive capacity was underutilized for many years, as was emphasized in chapter 1. When capacity is underutilized, it tends to reduce the average return on investment, and consequently new capacity creation is deterred.

On the other hand, real interest rates remained very high until 1982 (38 percent in 1975–82), which undermined the financial position of many enterprises and discouraged new projects. After 1982, interest rates were reduced sharply, with some intervention by the authorities, but an additional negative factor was added: the foreign debt service. This implied that a significant share of domestic savings was not invested domestically but was used for interest payments to foreign creditors. Consequently, a much more intense effort was required from domestic savings or other foreign funds to finance investment in Chile.

A last factor that discouraged productive investment was that entrepreneurs devoted a significant portion of their efforts to the purchase of existing assets in a highly active process of property transfers. These were induced by the recessive imbalances that prevailed for many years in the Chilean economy, by an intensive privatization of state-owned enterprises, and later by the government takeover of private enterprises that had gone bankrupt in the early 1980s and were subsequently subjected to reprivatization. But also, in another policy shift toward pragmatism, there were significant incentives for the private sector to invest in exportables and public utilities. As shown in Moguillansky 1999, huge transfers took place, given the form of privatization or reprivatization that was conducted; by means of the rescue of agents caught in the debt crisis; the economic rents involved in debt-equity swaps (see chap. 7); the highly efficient drawback to exporters, and, of course, the much needed dramatic exchange rate devaluation.

The analysis of productivity in chapter 1 showed that the global productivity of investment, corrected by the rate of utilization, was lower than in the 1960s (see table 1.3). How can this be reconciled with the idea that productivity was much higher after the opening of the economy and the liberalization of markets? The answer is that the surviving enterprises tended to be more productive, indeed (Tybout, de Melo, and Corbo 1991), but this was offset by a higher mortality rate among enterprises and a lower rate of utilization of productive capacity.

On the other hand, there was greater heterogeneity among the surviving enterprises, including the new ones, than in previous years. Modernization reached into many economic sectors, but it took a long time to reach the majority of them. For example, there are peasant sectors, small businesses in trade and services, industrial workshops, and self-employed individuals who had serious capitalization difficulties and operated, in part, with lower productivity and income levels than twenty years ago. They managed to stay in business or find a job by scaling down their incomes.

The foregoing coexisted with the benefits of having a growing segment of highly productive and dynamic enterprises, both urban and rural. After the crisis, the surviving firms tended to be stronger than the average firm before the reforms. This was an important and positive legacy for the future. The export-oriented economic policies and the establishment of a market for natural resources and land (which was certainly aided by the previous land reform) provided the favorable breeding ground that enabled entrepreneurial initiative, particularly among members of the younger generation, to venture into risk taking and an exploration of new forms of production.

Macroeconomic Balances

Basic macroeconomic balances relate to the amount of money issued, the gap between export earnings and import expenditures, and the fiscal budget. Excessive and persistent imbalances in all of these areas have caused severe crises, hyperinflation, and recessions in the past. There is a fourth balance, which should be included in macroeconomic equilibria, although it seldom is, consisting of the relationship between the generation of new productive capacity and the increase in actual output (or use of capacity). The magnitude of this gap affects very significantly the level of capital formation and subsequently productive employment.

In general, the Pinochet government was very cautious with regard to monetary expansion and maintained the fiscal budget either balanced or in surplus. A positive consequence of these policies was moderate inflation (by Latin American standards). Nevertheless, there is evidence that such policies are a necessary but insufficient condition for economic stability. In fact, the external sector underwent a prolonged and rising deficit, which was financed with external borrowing for a long period of time (from 1977 to 1981). This led to the 1982 crisis. Furthermore, during most of this period there prevailed a large gap between productive capacity and its utilization (see fig. 1.1).

Following the severe economic recession of 1982 and a few subsequent years marked by uncertainty, a strong and sustained recovery of economic activity began in 1986. In 1986–87, this recovery took place in a relatively stable macroeconomic setting, with a progressive decline in the capacity utilization gap. However, in the following two-year period the situation changed: demand and economic activity expanded at great speed (at more than twice the speed of increase in capacity), and this culminated, in 1989, in an overheated economy when the growth rate of GDP reached 10 percent. The great expansion was led, principally as of late 1987, by an increase in private aggregate demand as a result of a considerable monetary expansion, a significant reduction in taxes, and real exchange rate revaluations, which made imports cheaper.[12]

Real aggregate demand grew very fast in 1988–89, by 22 percent; GDP increased by 18 percent, a deviation from the government's plans, which were aimed at 9 to 10 percent growth in GDP throughout the two

12. The private sector's amount of money (M1A) increased by 56 percent in the twelve month period ending in October 1988 (the same month in which the plebiscite that the Pinochet government was forced to call was carried out). Taxation decreased by approximately 4 percent of GDP in 1988–89, and the real exchange rate underwent a 12 percent revaluation between January 1988 and June 1989, when the Pinochet government was forced to reverse this policy due to the accelerated increase in imports.

years and also contemplated a smaller increase on the demand side. The gap between expenditure and production was covered by the unexpected improvement in the terms of trade (i.e., the price of copper and other items). Productive capacity expanded only by roughly 7 to 8 percent in the biennium. The increase in GDP was based on the existence of installed capacity, which became exhausted in 1989 (see fig. 1.1), when the economy became overheated.

This imbalance became evident with a notorious acceleration of inflation and a strong rise in imports. In fact, on an annualized basis, inflation reached 31 percent between September 1989 and January 1990, a threefold increase over the 10 percent rate recorded by the end of 1988. The volume of exports experienced a vigorous increase of 23 percent during the biennium, but imports grew by 41 percent. The gap was covered by the extraordinary inflow of funds generated by the previously mentioned improved terms of trade. This improvement was centered on the price of copper, which doubled between 1985–86 (U.S.$0.63) and 1988–89 (U.S.$1.24). Copper represented half of Chile's exports, was produced primarily by a state-owned enterprise, and yielded high revenues from taxes and profits to the government.

Due to the existing maladjustments, the Pinochet government was forced to carry out successive adjustments, which included a devaluation in June 1989, adjustments to the financial market in April and September of 1989, and finally a sharp one in January 1990.[13] Thus, in March 1990, when President Aylwin took office, interest rates were notably higher, reaching real levels of over 16 percent for loans.

In short, when the democratic government was inaugurated in 1990 there was a macroeconomic imbalance, and an adjustment process was already under way in order to correct it. On the other hand, actual GDP had reached the productive frontier, and consequently any additional increase of output required, in contrast to the preceding years, a concurrent increase of productive capacity.

13. The latter was carried out after the Central Bank had begun operating, according to the tailor-made legal framework established by the Pinochet regime, which was enforced as of December 9, 1989, that is, five days before the presidential election.