

CHAPTER 2

The Neoliberal Experiment: From Reforms to the Crisis of 1982

During the 1970s, the Southern Cone of Latin America witnessed the pioneering implementation of broad neoliberal economic reforms. The most orthodox and comprehensive neoliberal example is that of the model imposed in Chile between 1973 and 1982.¹

There are four reasons for the particular relevance of the Chilean experiment. First, Chile was noted for its long democratic tradition and the broad pluralism characteristic of its institutions and citizens. After the coup in 1973, an authoritarian regime was established during which the neoliberal model was developed. Under the aegis of this regime, the executors of the economic model enjoyed exceptional autonomy in the design, implementation, and adjustment of their policies. Second, the Chilean experiment is an outstanding example of the contemporary application of monetarist orthodoxy because of its "purity," depth, and extensive coverage. Third, its prolonged survival, nearly one decade, provides a broad field for the assessment of its effects. Fourth, the case has been widely publicized as a "success," with the support of representatives of some international institutions, financiers, and "neoliberal" circles, which tend to give absolute priority to "economic freedom" over any other dimension of human activity. The experiment has frequently been cited by these media as a model for other developing countries. Hence, an understanding of its real features and the results it has provoked has a significance that goes beyond the particular case of Chile.

In this chapter, we shall study, first, the most characteristic features

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1. The model imposed in Chile has been variously described as orthodox or global monetarism. The authorities referred to it as a social market economy model. The last denomination leads to misinterpretation when it is confused with approaches such as that of the Federal Republic of Germany and those that give priority to social aspects. These are humanistic approaches as opposed to the "economicistic" approach of neoliberalism.

of the economic model. Then comes an analysis of the policies implemented in three strategic areas of the model, that is, the anti-inflationary program and the financial and trade reforms. There follows an exposition of the main results in relation to national production, income and wealth distribution, and the implications of the results obtained for future growth, especially with regard to the investment-saving process. The chapter closes with a brief recapitulation of the lessons provided by this orthodox neoliberal experiment.

My assessment shows the failures of neoliberalism in three strategic areas, which prevent it from working efficiently in developing economies. First, the heterogeneity of productive structures, sectoral and regional problems, and persistent market segmentation present demanding challenges to the efficacy of global economic policies. A growing but minor segment of increased productivity coexisted with numerous bankruptcies and a deterioration of income and employment quality in most areas of the economy. Second, the initial inequality among economic agents, which are indiscriminately thrown into competition among themselves, causes the overall liberalization and privatization, and the "neutrality" imposed on policies, to increase the concentration of economic power. Third, the presence of destabilizing and asymmetrical trends in the adjustment processes, in the macroeconomic framework created by neoliberalism, has made them notably procyclical and exceptionally costly from a social and economic point of view. The macroeconomic environment tended to encourage speculative forces at the expense of real capital formation and productive development.

Central Features of the Model

In Latin America, there have been many attempts to establish economic policies that allow the market a larger role than it had before.² This, however, can involve a wide variety of intensities of market action in the role of the state, the ownership of the means of production, and the participation of different social forces in decision making and the distribution of the benefits of development.

It is undeniable that in 1973 there were substantial macroeconomic imbalances that had to be corrected. Likewise the economy was over-intervened, with excessive "microeconomic" controls over private and public enterprises. Evidence of this appears in the self-criticism advanced during 1972–73 by various spokesmen of Popular Unity, the governing coalition under President Allende (Bitar 1979, chap. 5).

2. Chilean experiences in 1952–70 are analyzed in Ffrench-Davis 1973. A comprehensive analysis of economic reforms in Latin America can be found in Ffrench-Davis 2000.

The size of imbalances and the open inconsistency of public interventionism facilitated the introduction of the orthodox neoliberal approach after September 1973. Thus in Chile, in contrast to other authoritarian regimes in Latin America, an extreme version of global monetarism was imposed (see Foxley 1983, chap. 2). The model under discussion is an extreme case because of the amplitude of the role assigned to the market, the intensive privatization of the means of production, and the change imposed on the social organization of the country. Various channels of social participation and development, which had arisen in the continuing process of democratization in Chile during the preceding decades, were suppressed or controlled after 1973.

The implementation of the model gave rise to substantial changes in the economic role played by the public sector. It implied a general withdrawal, gradual or abrupt, from the broad field of action covered by the state. This embraced public ownership,³ the active role of the state in development, and the orientation of indirect economic policies, which it was stated should become absolutely neutral.⁴ The principle of the subsidiary state was applied within markedly narrow limits and on the premise that the private market could assume numerous functions, which in fact it could not perform satisfactorily.

The structural transformations in the economy were carried out without the government having resolved the serious conjunctural distortions and macroeconomic disequilibria confronting the Chilean economy. This procedure was due in part to the priority assigned to structural transformations; it was thought then that a delay in initiating them might mean the loss of the opportunity provided by the authoritarian political framework and the widespread anti-interventionist atmosphere prevailing in large social segments that had been traumatized by supply shortages and bureaucracy, among other things, in 1973. Additionally, the proponents of the model claimed that the existing problems had resulted from statist and interventionist policies applied both during the regime of President Allende and in the four preceding decades, transcending governments that covered the entire political spectrum.⁵

The main economic transformations took place in the fiscal, financial,

3. Notwithstanding the intensity of privatization, public ownership was still more significant in Chile than in several other Latin American countries in 1982. The norm, however, was the passivity imposed on public enterprises. The case of the state-owned copper enterprise, which is described later, is an example of this.

4. The more extreme aspects of the model were not fully apparent at the outset. The economic team was taking shape and consolidating its hegemony between 1973 and 1975 and at the same time imposing its neoliberal approach. The peak of orthodoxy was reached in the early 1980s.

5. See statements by public officials in DIPRES 1978 and Moulián and Vergara 1979.

and labor fields, international economic relations, and public ownership of means of production; while later a profound social security reform was also introduced. In all of these areas, economic action by the public sector was persistently reduced throughout this period (Vergara 1981).

Fiscal policy comprised a tax reform and a restructuring and reduction of the greater part of public expenditure. The tax reform included the elimination of taxes on wealth and capital gains and a reduction of the charge on profits. On the other hand, the adoption of a value-added tax was completed and the existing exemptions for basic consumer goods were in general suppressed. The target was to reduce the tax burden, concentrating it in taxes that, in the opinion of the economic team, were "neutral." The official speech claimed that any differentiation "distorted" resource allocation (DIPRES 1978).

Public expenditure recorded as a share of GDP was reduced by over a quarter from the levels it had reached by the late 1960s,⁶ after having resulted in abnormally sizable expenditures and budget deficits in 1972–73. There was a dramatic decline in government investment, which diminished by more than half as a share of GDP between 1970 and 1979. Public expenditure also decreased in the productive sectors, in activities to support the private sector, in subsidies to public enterprises, and in infrastructure. Social expenditure, mainly on education, health, social security, and housing, increased its share in public expenditure. This was repeatedly proclaimed to be an indicator of the "social" character of the model. However, real per capita expenditure decreased, and it also declined as a share of GDP. As will be shown, the drop in public social expenditure per capita took place in the context of a marked increase in unemployment and deterioration in the real income of the middle- and low-income brackets. Therefore, the socioeconomic frame required, in contrast, a compensatory increase in expenditure.

In the financial field, a drastic reform was introduced in 1975. The banks that had been nationalized under the previous regime were returned to private ownership. Interest rates were left totally free, regulations respecting the terms and allocation of credit were eliminated, new financial entities were authorized with few restrictions, and easy access was given to foreign banks. Finally, there was a gradual relaxation of restrictions on capital flows.

With regard to international trade, practically all restrictions other

6. There are serious problems of comparability in the figures on public expenditure. Due to changes in definition and erroneous deflators, the official figures for social spending were overestimated. Homogenized figures for the period 1969–79 and an analysis of the main components appear in Marshall 1981. All the figures in the text come from that source. A comprehensive study of the distributive impact of public revenue and expenditure toward the end of the 1960s is contained in Foxley, Aninat and Arellano 1980.

than tariffs were removed, and these were rapidly reduced from the high level predominant in 1973 (a simple mean rate of 94 percent) to a uniform tariff of 10 percent for all goods since 1979. Likewise, trade liberalization resulted in the suppression of the price bands and public purchasing mechanisms designed to attenuate the transmission of external instability to the domestic economy. In line with the objective of the unilateral and across the board opening of the market to the world, Chile withdrew from the Andean Pact in 1976.

Privatization was not limited to transferring businesses expropriated during the regime of President Allende. It was also extended to enterprises created during successive governments after the establishment of the national Development Corporation (CORFO) in 1939. In 1970, CORFO controlled the ownership of forty-six enterprises, a number that rose to around three hundred in 1973.⁷ In 1980 there were only twenty-four enterprises left in the hands of this institution, half of which were in the process of being sold. There were also some dozen public enterprises dependent on other governmental departments. Among these were the Copper Corporation (CODELCO) and the National Petroleum Enterprise (ENAP).

The sale of enterprises was largely conducted in periods of domestic recession and very high interest rates. Hence, very few groups were able to consider their purchases. This was one of the reasons for the acute concentration of ownership during those years.⁸ In this process, there was little direct participation by transnational corporations, in contrast with the official expectations of a vigorous flow of foreign direct investment (FDI). However, a massive increase in loans from international commercial banks provided a substantial proportion of the financing required by the national economic groups acquiring the enterprises being privatized.

In the agricultural sector, the transfer of ownership had dramatic significance. The agrarian reform that had taken place during the governments of presidents Frei and Allende came to an abrupt end. After 1973, around 30 percent of the expropriated land was returned to its former owners and 20 percent was auctioned to nonrural dwellers. Barely one-third of the area was assigned to peasant farmers. Given the curtailment of one of the former functions of the state, that is, the provision of credit and technical support to peasants and cooperatives, these were some of the principal victims of the restructuring of public expenditure. It is estimated that as early as 1979 about half of the

7. This does not include about 220 enterprises subject to intervention in 1973. See Vergara 1981; Bitar (1979, chap. 10) examines the social property area program, its deviations, and resulting problems.

8. Additionally, it is estimated that the transfer was made at prices lower than normal market values. See Dahse 1979; Foxley 1983; and Marcel 1989.

peasants who had been assigned land had been forced to sell or rent out their farms.⁹ At the same time, a massive expulsion of peasants from the farms on which they had been living before and during the agrarian reform took place.

The dismantling of state participation in economic life was also extended to other areas. In very concise and by no means exhaustive terms, the network making up the agricultural "infrastructure" (such as cold storage plants, supply centers for seeds and inputs, purchasing power, and technical assistance to medium and small farmers) and the mining network (mineral-processing plants) can be mentioned.

In 1980, another major step in the process of privatization was taken in relation to the social security system. The retirement pension scheme, hitherto financed through a pay as you go system, was replaced with a system based on individual capitalization in private social security financing societies (AFP) created by the new system.¹⁰ Existing pensions and those of workers who would retire in less than five years continued to be the responsibility of the public sector; the rest of the workers could choose between remaining in the old system or transferring to an AFP. For merely making the transfer, the worker benefited from an automatic take-home pay increase of 11 percent. The choice between financing societies was to be made by the worker based on quality of service and an assessment of the expected return in each social security financing society during the length of time before his or her retirement. The expected return to the worker was determined by the various commissions he or she had to pay, which could be freely modified by each society, and the profits or interest obtained from the investments of each AFP.

One enterprise of great importance that resisted privatization was CODELCO. It underwent powerful onslaughts from the economic team but succeeded in warding them off. Even so, it suffered budgetary restrictions imposed by the Ministry of Finance despite the substantial profits it contributed to the Treasury. It was only permitted to make investments that allowed it to maintain the production level reached in 1977. Within the contradictions produced by the privatization dogma, the government encouraged, unsuccessfully hitherto, the development of other copper deposits to be operated by foreign companies. Paradoxically, these de-

9. Two financial factors that contributed to the pressure on peasants to sell or lease their allotted land were the high cost of credit in the domestic capital market and the lack of prior relations between the peasants and commercial banks. It seems to have been assumed that they would "compete" on equal terms with the other users. With reference to the agricultural and peasant situation, see Ortega 1987.

10. The characteristics of the pay as you go system, the new dispositions, and a comparative analysis with other options are discussed in Arellano 1985.

posits, although rich in a world context, were less so than those mined by CODELCO, which suffered systematic constraints on its expansion.¹¹

One feature of the official antistate approach was the persistence of the privatization process, even during the serious 1982 crisis. The government constituted a commission to sell assets as part of an "economic recovery program."

Parallel with the changes in the economic field were structural reforms in social organization. According to the official rhetoric, these were part of the project to create a competitive society of "free men." This involved changes in the university system, in the organization and dependence of elementary schools, and in health services, professional, associations, and student and labor union organizations.¹² The last case was undoubtedly functional in imposing a policy that caused average real wages in 1981 to be even lower than in 1970 and 1971.

Neoliberalism in Three Strategic Areas

One of the distinctive features of neoliberalism is its globalism: its neglect of problems of a sectoral nature, of the heterogeneity of the productive structures and access to power of different sectors, of the significance of market segmentations, and of the difficulty of transmitting information to economic agents so that they can contribute to fulfilling the expectations of public policy. Ultimately, it underestimates the frequent presence of destabilizing adjustment processes and lags and overshooting. These elements represent inescapable obstacles that prevent "neutral" and indirect global economic policies alone from being effective in developing nations or those in the process of deep transformation like Chile was.

In this section, we consider three "neutral" policy reforms to which the government assigned a prominent role. This, in fact, they achieved but with an outcome different from what had been foreseen. First, the anti-inflationary policy and the extreme closed economy monetarism that was applied until 1976, and the subsequent extreme open economy monetarism imposed between 1979 and 1982, are considered. The financial reform introduced in 1975 is analyzed, and finally a brief discussion on trade and financial reforms is presented.

11. See Vignolo 1982. The main foreign investment, made by Exxon through the purchase of a deposit in exploitation, is discussed in Tironi and Barría 1978. Also see Bande and Ffrench-Davis 1989.

12. See Brunner 1981; Campero and Valenzuela 1981; Moulián and Vergara 1980; Vergara 1981; and various articles in *Revista Mensaje*, especially Ruiz-Tagle 1979; 1980; 1981; and Zañartu 1980.

The Anti-inflationary Policy

Until 1976, monetary policy constituted the instrument on which anti-inflationary action was based.¹³ In the twelve months prior to September 1973, inflation had reached an annual rate of 400 percent, and from May to August of that year it was about 19 percent per month (an annualized rate of 700 percent).¹⁴ The fiscal deficit was close to 14 percent of GDP, strongly influenced by price controls on the goods and services sold by public enterprises.

Price controls, which extended to broad areas of the private sector, involved heavily repressed inflationary pressures and an extensive black market (Bitar 1979). A few days after the coup, most of the controlled prices were freed within a context of high uncertainty. The foreseeable result was a dramatic upsurge in inflation, which soared to 88 percent in one month and reached 590 percent in the course of the first year of application of the model. Undoubtedly, there was an overshooting of market prices, which exceeded by far the inflationary pressures previously repressed. As the fiscal situation was being brought under control, the monetary policy became effectively restrictive in the course of 1974. The official line was that the new price fixers, the private entrepreneurs, had to take money supply behavior into account in order to define the price of their products. It was claimed that in their own best interest they would restrict price increases in order to maintain their market share. And this they would promptly do as soon as they observed a reduction in the expansion rate of the money supply.

The concrete fact is that the information on money supply became widely available with a delay of some months and with various divergent indicators, and that prices, given the high inflation, were often adjusted even more frequently than once a month. Under these circumstances, the main point of reference for each economic agent became the actual behavior of entrepreneurs as a whole, measured through changes in the official consumer price index (CPI), the only easily available and up-to-date indicator. This indicator was published early in each month with reference to the preceding period. The consequence was that annual inflation rates exceeding 300 percent persisted until far into the third year of application of the model, despite monetary restrictions and a fiscal budget already under control in 1975.

The monetary restrictions, rather than influencing prices, had a

13. Anti-inflationary policy is discussed in greater depth in Corbo 1985; Foxley 1983; and Ramos 1975, 1986.

14. All the inflation figures used here refer to the consumer price index as corrected in Cortázar and Marshall 1980. The official index significantly underestimated the effective rise in prices, mainly in 1973 and in 1976–78.

greater impact on the level of economic activity: during 1975 industrial production fell by 28 percent, GDP declined by 17 percent,¹⁵ and open unemployment (including emergency programs) peaked at 20 percent.¹⁶ The "price," which was in fact adjusted swiftly downward, was wages: around 1975 they had lost about 40 percent of their purchasing power owing to the legal readjustment based on an underestimated CPI and the drastic repression of unions.

The monetarist recipe for controlling inflation did not function in the way predicted by the supporters of the model. On the contrary, it multiplied the effects deriving from the international recession and involved a notably high cost both socially and in terms of economic activity (see Foxley 1983; Ramos 1986).

As late as mid-1976, the economic team recognized implicitly that monetary control was proving to be incapable of restraining inflation on its own. Then a second variable was incorporated into the anti-inflationary policy—the regulation of the exchange rate conditioned to that objective. Thus began a long process in which the exchange rate was used to slow inflation by reducing the cost of imported goods and attempting to influence inflationary expectations: analytically, it was a transition from closed to open monetarism. In June 1976 and March 1977, exchange rate revaluations were made (a reduction in the number of pesos per U.S. dollar), which were accompanied by a systematic mass media campaign.¹⁷ The measure had a significant effect, since inflation rapidly fell to levels below 100 percent annually after the first revaluation and below 60 percent after the second. There was a belated realization that the inflation was not being generated by an excess of demand and monetary expansion; it is evident that misinterpretation of the workings of markets involved huge social and productive costs for Chile. The belated realization was, moreover, incomplete, since only one additional policy instrument was applied; that is, the exchange rate. This implied its excessive conditioning to the anti-inflationary policy, thereby sacrificing external equilibrium and the production of exportable goods and services.

15. In the course of 1975, a severe balance of payments problem arose. This was associated with a sharp fall in the terms of trade, which the government tackled by intensifying the restriction on the money supply, curtailing fiscal expenditure, and imposing a devaluation. The impact of the terms of trade deterioration was multiplied by three in the domestic economy. The direct impact of the deterioration in the terms of trade observed in 1975 is discounted in the figure for GDP decline. GDP measures real output; the terms of trade impact affects income.

16. The serious shortcomings of the official employment figures and a series corrected for the period 1970–85 are provided in Jadresić 1986.

17. After the publicized revaluations, daily minidevaluations were applied. The exchange rate policy is analyzed in detail in chapter 4.

The anti-inflationary policy culminated in 1979 in the freezing of the exchange rate, once again supported by the weight of publicity in the mass media. The new official version was that, with a fixed exchange rate in an economy with free imports, as the Chilean economy was then, domestic prices could not rise more rapidly than international inflation. At this late stage, therefore, they had adopted the "balance of payments monetary approach" then in fashion in several academic and orthodox financial circles. Thus, the implementors switched from a closed economy monetary approach, the official doctrine up to 1976, to an open economy model. In the former case, domestic inflation was considered to be the *exclusive* result of monetary expansion. In the latter case, domestic inflation was assumed to be due to international price changes plus exchange rate variations; with the exchange rate frozen, there should be rapid equalization of domestic and external inflation.

When the exchange rate was pegged (June 1979), domestic annual inflation was above 30 percent, while international inflation was near 12 percent. The convergence between the two rates occurred slowly; for a year and a half, domestic inflation was markedly higher than the international rate, so that the exchange rate lost purchasing power. Hence, the regime of free imports and an appreciated exchange rate caused a flood on the domestic market and an unsustainable disequilibrium in the current account during 1981; between 15 and 21 percent of GDP depending on the measurement criteria (see chap. 5). To face the external deficit, the official policy relied on an "automatic adjustment" in the style of the gold standard in force before the world crisis of 1929: it claimed that the real exchange rate would automatically adjust with the contraction of monetary liquidity associated with the current loss of international reserves in the Central Bank. This contraction should have provoked a drastic fall in domestic prices and nominal wages. However, a detail apparently overlooked was the fact that the exchange rate between 1979 and 1981 had accumulated a 30 percent appreciation (besides the lagged effect of import liberalization, as analyzed in chap. 3). The actual adjustment was in the right direction, but with a lag, and then only in a small proportion when negative inflation rates were achieved in some months of 1982. At the same time, however, there was a drastic fall in sales, production, and employment — the most severe recession experienced in 1981–82 in Latin America — and a progressive strangulation of business firms through increasing indebtedness at extremely high real interest rates.

Despite numerous tough restrictions on labor union activities and a real wage that remained below the average level of 1970, the authorities blamed salaries for their failure to achieve a fluent and rapid automatic

adjustment.¹⁸ In mid-1982, they tried to effect a general reduction of wages, but the economic team was unable to impose such a measure. Consequently, they turned to exchange rate devaluation.

The final outcome, in mid-1982, was an inflationary phenomenon repressed to levels lower than those of the industrialized nations¹⁹ but with unsustainable disturbances in the productive and financial systems, which led to massive devaluations: between June and October of 1982, the exchange rate was devalued by more than 70 percent amid a general crisis.

Reform of the Financial System

At the end of 1973, the commercial banks were mainly in the hands of the state as a result of nationalization by the previous government.²⁰ During 1975, most banks were auctioned back to the private sector. The most important commercial bank, the Banco del Estado, founded in 1953, remained public, but its market share fell from about 50 percent at the beginning of the decade to 14 percent of all outstanding loans in 1981. Earlier in 1974, authorization had been given for the creation of private financing societies that could receive and lend resources at a freely determined interest rate. Meanwhile, banks remained subject to a legal maximum interest rate until April 1975. This and other measures that discriminated against banks while they remained public contributed to the boom of the new financing societies. Discrimination was also directed against the savings and loan cooperative system (SINAP), which was linked to the acquisition of housing. The notorious discrimination against this organization caused the funds received by SINAP to decrease from 28 percent of total financial loans in 1973 to 7 percent in 1977.

In addition to freeing the interest rate, in 1975 the government eliminated the norms relating to the quantitative control of credit in national currency and the selectivity of bank reserve regulations, which

18. The lower limit for the adjustment in wages was determined by the official CPI of the preceding period. Various authors blame this rule for the costly recessive adjustment. Nonetheless, there was no knowledge of cases of massive deflation that resulted from restriction of the money supply, which operates fluently, at the required intensity, and without causing severe problems for debtors or economic activity. The sticky prices model continued to be a reality around the world in addition to legal readjustment norms.

19. It is important to point out that the external inflation confronting the Chilean economy was negative, owing to the appreciation of the U.S. dollar in relation to the currencies of other industrialized countries: a weighted index of external prices, converted into dollars, from May 1981 showed deflation. Between that date and June 1982, external inflation reached an annual average of -2 percent.

20. Financial reform will be examined in detail in chapter 5.

were largely intended to channel funds into production rather than consumption. Moreover, restrictions relating to maturity terms were removed (except for a general restriction of thirty days minimum). Next a gradual uniformity was imposed on the different financing institutions for both the operations permitted and their conditions. Within this trend toward uniform treatment came the deregulation for foreign banks. In December 1974, the restrictions on their operation in Chile were eliminated. In 1982, there were nineteen foreign banks operating in the national market. But despite their accelerated growth they captured only 10 percent of banking loans.

The economic team expected that the liberalization of the domestic financial market, accompanied by the gradual opening of the capital account, would lead to an increase in national savings and the quality of investment, in response to the suppression of former subsidies and the removal of discrimination between credit users. The result was strikingly different and placed the financial reform and the handling of the external sector at the core of the economic crisis that surfaced in 1982.

The two most outstanding features of the functioning of the domestic capital market were the maturity terms and the interest rates that prevailed during the seven years between 1975 and 1982. The most common term for deposits and loans was thirty days, with a sharp drop in long-term funding. The average real interest rate (discounting inflation) was on the order of 38 percent annually during 1975-82, covering a range varying from 12 to 120 percent (see table 5.5). In other words, real interest rates in the domestic market, apart from a markedly high average level, varied enormously throughout the period.

Medium-term credits available at international rates were mostly those related to external loans. These were mainly available to enterprises connected with banks and to "economic groups" (principally, the so-called Piranhas), which grew like wildfire during the period under discussion (see Dahse 1979). The notable market segmentation to which this gave rise was partially recognized only shortly after the emergence of the crisis. In mid-1982, it became public knowledge that the principal bank of the largest economic group had 42 percent of its total loans (financed with domestic and external funds) in companies related to its directors or owners.

Repeatedly throughout the seven years of the financial reform, advocates of the model predicted decreases in real interest rates. Only during 1980 was there a significant drop in the real financial cost, which lasted for nine months. This was associated, on the one hand, with the freezing of the exchange rate during the whole year and with average domestic inflation still above 30 percent annually. Hence, the real cost of foreign loans was negative (-8 percent) for national debtors. On the