CHAPTER 3

Import Liberalization: The Chilean Experience in 1973–82

The distinctive characteristic of trade policies implemented in 1973 was the sharp import liberalization, which was undertaken to a degree then unprecedented in modern economic history, either in Chile or in any other semi-industrialized country. By establishing a uniform tariff of 10 percent on nearly all imports, this liberalization suppressed all selective criteria for regulating them. Trade liberalization was accompanied by an opening to foreign investment, also unrestricted, and by a reduction in restrictions on foreign exchange dealings and capital flows (for a detailed analysis of the financial reform, see chap. 5).

The implementation of free trade raises four questions. First, did the policy allow more efficient use of available resources or did it produce significant new divergences between market and social "efficiency"? Second, what degree of dynamism characterized the process, compared to its historical behavior, and how did the intensity and timing of liberalization affect employment, investment, and consumption? Third, how much competition or economic concentration did the policy reform produce? Last, how effectively "neutral" were these "nondiscriminatory" economic policies? Policies, seemingly neutral, were applied to different segments of the economy that coexisted in a framework marked by inequalities and productive heterogeneity. This implies that these policies may produce asymmetrical effects among different productive and social groups.

It is evident that the effects of a deep process of reforms need a long time for completion. Nevertheless, given a positive time preference rate, it should be kept in mind that a peso today will be worth more than twice as much as ten years later. On the other hand, many other policy changes were implemented together with trade reform, making it difficult to distinguish between the effects of each of them. Finally, there were different

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effects on tradables, giving a positive impulse to the production of exportables and a negative one to importables. Mainly, we are referring to the transfer of innovations through exposure to foreign competition (Lüders 1980; Tybout, de Melo, and Corbo 1991).[1]

At the beginning, I would like to remove from consideration the simplistic dilemma that the only alternative to the reform implemented, with all its details, would have been to maintain the chaotic situation of 1973. Why, for instance, was the pragmatic version of the trade reform applied between 1968 and 1970 not continued? Its main features were gradual implementation, complementarity of export promotion, reduction of the variance and average of effective protection (i.e., of variance and average of the import tariff), and an active crawling peg exchange rate policy consistent with the reform (see Ffrench-Davis 1973, chaps. 3 and 4).

The next section shows the path followed by the reduction of import restrictions, focusing on tariff liberalization and the evolution of the real exchange rate in order to determine to what degree this macroeconomic price played the compensatory role assigned by official policy. I then analyze the behavior of the principal categories of imports (in particular, consumption goods) and examine some distributive effects. Next the general impact of import liberalization on manufacturing and employment is investigated, and the effects of liberalization are illustrated by examining the impact of disaggregated information on the performance by industrial branches. Finally, I present the main conclusions.

The Import Liberalization Process

Chile's trade liberalization scheme is the oldest and longest continuously applied program in Latin America. In late 1973, before the introduction of reforms, Chilean foreign trade was subject to a great deal of government control:[2] a simple tariff average of 94 percent, countless nontariff restrictions, and multiple exchange rates.

A remarkable reduction in the extremely high barriers that protected import substitutes constituted the core of the new trade policy. The rapid liberalization process, which began in 1973 and ended in June 1979, induced a drastic change in market comparative advantages by modifying both the profile of effective protection and its average.

1. In this chapter, I will focus on import policies. Export policies, their effects, and the interrelationships between both dimensions are examined in Ffrench-Davis 1979b; and Ffrench-Davis, Leiva, and Madrid 1992. The export model in the 1980s and 1990s is analyzed in chapter 8.

2. Notice that this was the situation in 1973. However, in the second half of the 1960s there was a reform in progress that included the gradual rationalization of the import regime and the improvement of mechanisms of export promotion (Ffrench-Davis 1973).

During the period of liberalization, the target of the process underwent significant changes. What initially appeared to be a moderate reform, with maximum tariff rates of 60 percent, in the end became a drastic revamping of the tariff structure with a final uniform tariff of 10 percent.

The first steps in the process consisted of suppressing the main nontariff barriers and dropping to 220 percent all tariffs that were above that level. Most import prohibitions and deposits were eliminated. These import deposits, with a rate of 10,000 percent, which were charged on more than half of the imports, constituted one of the most common mechanisms used to regulate imports in 1973. The deposits were waived on the condition that importers fixed their volumes within the quotas recommended by the government. Since this mechanism was applied along with an undervalued exchange rate to several thousand products, it generated countless supply bottlenecks and speculative windfall gains for importers. The "normalization" of the foreign exchange market (see chap. 4), which took place in October 1973, and a significant increase in the price of copper during the second half of that year facilitated the rapid removal of quantitative restrictions and initial tariff reductions.

In early 1974, the government announced a tariff liberalization scheme that would take place gradually over a three-year period and indicated that it would proceed pari passu with real exchange rate depreciation. The finance minister asserted that it would generate export-led growth and that workers would benefit, "as it would create more jobs in expanding sectors than the number of jobs that could disappear in some highly inefficient sectors."[3] The announcement gave no indication of the levels tariffs were projected to reach.

The first such indication came in May 1974, when the government declared that "in 1977, no tariff will be higher than 60 percent. This clearly defines the tariff policy that will be followed in the future, so that domestic industries can make whatever adjustments are necessary and prepare themselves so that they will be in good shape to meet foreign competition."[4]

Despite these announcements, the tariff policy still was not really defined, as strategic differences emerged between proponents of a fully orthodox policy and other important government officials possessed of a more pragmatic bent. Toward the end of 1974, it was informally hinted that the maximum tariff rate in the future would only be 30 percent. Internal government documents mentioned a range of 25 to 35 percent, within which the majority of tariff rates would fall (De la Cuadra and

3. Statement of January 7, 1974, reprinted in DIPRES 1978, 61.

4. Comments of the finance minister, October 1974, reprinted in ibid., 107. The minister reconfirmed this goal on April 24, 1975 (172).

Hachette 1992; Hachette 2000). Later, in 1975, the government announced that the range of tariff rates would be placed between 10 and 35 percent and that it would be reached during the first half of 1978, by gradual reductions.

Although step-by-step the apparently more pragmatic official policy gave way to the free trade approach, the policy as it was presented by 1975 contained two important heterodox elements. On one hand, it contemplated nonuniform tariff rates (from 10 to 35 percent) according to the degree of elaboration of different categories of products. On the other hand, it also contemplated maintaining the tariff preferences agreed upon under the Andean Pact, which meant that tariff reductions for several products stopped at the minimum common external tariff in place in 1972–76, according to the Cartagena Agreement (Aninat 1978).

The gradual tariff reductions were made approximately once every six months, as can be seen in table 3.1. Nevertheless, the final reductions, scheduled for the first half of 1978, were completed in August 1977, when 99.6 percent of all tariffs reached the 10 to 35 percent range, with a 20 percent simple average.

It seemed from repeated official statements that the reduction of protection for import-substituting firms had been completed in August

TABLE 3.1. Tariff Liberalization, 1973–79 (rates on *cif* value)

	Maximum Tariff		Modal Tariff		Simple Average	No. of
Date	Rate (%) (1)	% of All Items (2)	Rate (%) (3)	% of All Items (4)	Tariff (%) (5)	Items (6)
12/31/73	220	8.0	90	12.4	94.0	5,125
3/1/74	200	8.2	80	12.4	90.0	5,125
3/27/74	160	17.1	70	13.0	80.0	5,125
6/5/74	140	14.4	60	13.0	67.0	5,125
1/16/75	120	8.2	55	13.0	52.0	5,125
8/13/75	90	1.6	40	20.3	44.0	4,958
2/9/76	80	0.5	35	24.0	38.0	4,952
6/7/76	65	0.5	30	21.2	33.0	4,956
12/23/76	65	0.5	20	26.2	27.0	4,959
1/8/77	55	0.5	20	24.7	24.0	4,981
5/2/77	45	0.6	20	25.8	22.4	4,984
8/29/77	35	1.6	20	26.3	19.8	4,985
3/12/77	25	22.9	15	37.0	15.7	4,993
6/78	20	21.6	10	51.6	13.9	4,301
6/79	10	99.5	10	99.5	10.1	4,301

Source: Central Bank of Chile.

Note: Dates refer to the official decrees on general changes of custom tariff rates between December 1973 and December 1977. On the latter date, the government issued a decree of monthly adjustments that lasted until June 1979.

1977. Three months later, however, the finance minister announced another policy change: a target tariff of a uniform 10 percent to be reached in mid-1979. The additional tariff liberalization was carried out in monthly steps between December 1977 and June 1979. By the later date, a uniform tariff of 10 percent was being charged on nearly all imports into Chile. Nontariff restrictions, which were generally inefficient and generated capital gains, had been mostly eliminated; and several hundreds of tariff exemptions in favor of firms, regions, or individuals had been suppressed (De la Cuadra and Hachette 1992). But mechanisms softening the transmission of external instability were also eliminated. Imports of nonproduced capital goods, which had been generally exempt from tariffs, now became subject to them, although they were paid in installments.

Evidently, relative prices changed as compared with those of imports of capital goods and in favor of imports of consumer goods.

The 10 percent flat rate was unusually low for developing countries in the 1970s, and even in developed countries a uniform rate was exceptional. Some comparative information illustrates this. In a semi-industrialized country such as South Korea, even after a decade of following its successful overall economic policies, tariffs still ranged between zero and 150 percent, with many locally produced items enjoying nominal rates of protection between 30 and 60 percent.[5] Korea as well as Taiwan and other Asian countries had carried out a profound trade reform led by export promotion rather than import liberalization (see Ffrench-Davis 2000, chap. 3).

Developed countries, despite their position at the forefront of world industry, usually maintained selective (nonuniform) rates of protection for different products, with levels notably higher than 10 percent for significant groups of items. Effective tariff protection in the United States, Japan, and the European Economic Community was relatively high for product categories such as textiles and clothing, processed food, and light manufactures. For instance, textiles and clothing enjoyed effective tariff protection of about 40 percent in these countries. In Japan, the effective tariff protection on processed food was 68 percent.[6] Imports

5. See Balassa 1977, 148–51; and Frank, Kim, and Westphal 1975. For other developing countries analyzed in a comprehensive project by the National Bureau of Economic Research (NBER), see Bhagwati 1978. An earlier study by Little, Scitovsky, and Scott (1970) includes a fine theoretical analysis that supports the use of selective (moderate) tariffs. See also Ffrench-Davis 1979a, chaps. 7–9.

6. Mendive 1978. The dispersion of effective rates of protection by items or "products" was very high; for example, cigarettes had a rate of 405 percent in Japan, refined oil a rate of 466 percent in the United States, and butter a rate of 1,300 percent in the European Economic Community. The background information refers to the pre-Tokyo round of the GATT negotiations.

into these countries were restricted by many nontariff mechanisms (Baldwin 1981) that were significantly affecting a growing number of industrial exports from developing countries. Estimates for 1973 covering France, the United States, Japan, and Sweden indicate that for twenty-six chapters of the tariff schedule the average ad valorem rates of protection of nontariff regulations (such as health regulations, import quotas, "voluntary" export restrictions, and import licenses) were as high as 40 to 90 percent (Roningen and Yeats 1976).

After 1973, public officials stated repeatedly that the real exchange rate would depreciate as effective protection dropped (DIPRES 1978, 275, 291). The government declarations implied an extremely naive view of causal relationships in the economy, one that is valid only for a competitive model without capital flows. In practice, however, the large capital inflows implied significant deviations from this supposed univocal causal relationship.

In fact, during periods in which the most sizable tariff reductions were made, the real exchange rate appreciated in tandem. Table 3.2 shows the evolution of the real exchange rate (col. 1), nominal rates of protection for items subject to the maximum and average tariffs (cols. 3 and 4), and the total cost per dollar of imports (col. 5) on selected dates. Dates were selected according to the evolution of the cost of imports and

TABLE 3.2. Cost of Imports, 1973–82

		Real Exchange Rate[a]	Change in (1) in Each Phase	Nominal Tariffs (%)		Average Total Exchange Rate[b]	Change of (5) in Each Phase
Phase	Date	(1)	(2)	Maximum (3)	Average (4)	(5)	(6)
	10/73	59.20		220	94	114.85	
1			67.2				31.0%
	4/75	98.98		120	52	150.45	
2			−39.4				−51.4%
	7/77	59.96		45	22	73.15	
3			14.2				2.9%
	6/79	68.46		10	10	75.31	
4			−31.3				−31.3%
	6/82[c]	47.02		10	10	51.72	

Sources: Central Bank of Chile, *Boletín Mensual,* various issues; Ffrench-Davis 1984; table 3.1.

[a]Nominal exchange rate deflated by the corrected CPI (see Cortázar and Marshall 1980) and multiplied by the index of external prices in 1986 prices.

[b]Obtained by multiplying column 1 by [1 + (4)/100].

[c]Monthly average until the day before devaluation.

the relation between the two components that are considered here: the exchange rate and nominal tariffs.[7]

Using this information, we can distinguish four phases in the liberalization process (see fig. 3.1).

The tariff reductions in phase 1, which lasted from the end of 1973 until April 1975, were made when exchange rates were very depreciated, particularly following late 1974. Moreover, a significant portion of the notably high tariffs were then redundant, which meant that the initial reductions did not have substantial effects, as they represented mostly "water" in nominal protection.[8] Because of this, there were no significant increases in "nontraditional" imports during this phase.

During phase 1, the average cost of a dollar's worth of imports increased by 31 percent. Hence, the reform process was principally one of "rationalization" in which the large dispersion of effective protection rates was diminished without causing a substantial impact on manufacturing of import substitutes. However, the latter industries suffered the negative effects of the strong recession then in progress. Import liberalization and exchange rate depreciation did have a positive effect on exportables; given that exports previously enjoyed customs exemptions for imported components, it was the exchange rate policy that had stronger effects on increasing exports (Ffrench-Davis 1979b).

The situation faced by importable goods changed substantially during phase 2, which lasted from April 1975 until mid-1977. During this period, reductions in nominal protection were more effective than in phase 1, dropping from an average of 52 to 22 percent, and the maximum nominal protection decreased from 120 to 45 percent. The exchange rate appreciated by 39 percent, strongly reinforcing the effects of reduced tariffs. Thus, for two years, as the tariff liberalization was carried out, the real exchange rate was revalued in parallel. Consequently, the thirty-point reduction in the average nominal tariff meant a 51 percent fall in the average cost of each dollar's worth of imports (table 3.2, col. 6). There was little chance for the market to gradually adjust to the

7. The selected dates are somewhat arbitrary, since the real exchange rate levels are sensitive to the price indexes used to calculate them. The average tariff also can be calculated in very different ways. I present here the simple average used by different government and independent sources. It is well known that the simple average is very sensitive to the extent of disaggregation.

8. Obviously, the nominal tariff for several items, in particular for consumer goods, dropped notably more than the decrease in the average tariff. The corresponding reduction in effective protection was even sharper. Therefore, for many of these categories the real exchange rate depreciation did not compensate for the effects of tariff liberalization. Data on effective and nominal tariffs before tariff liberalization appear in Behrman 1976, 137–44; and in De la Cuadra 1974.

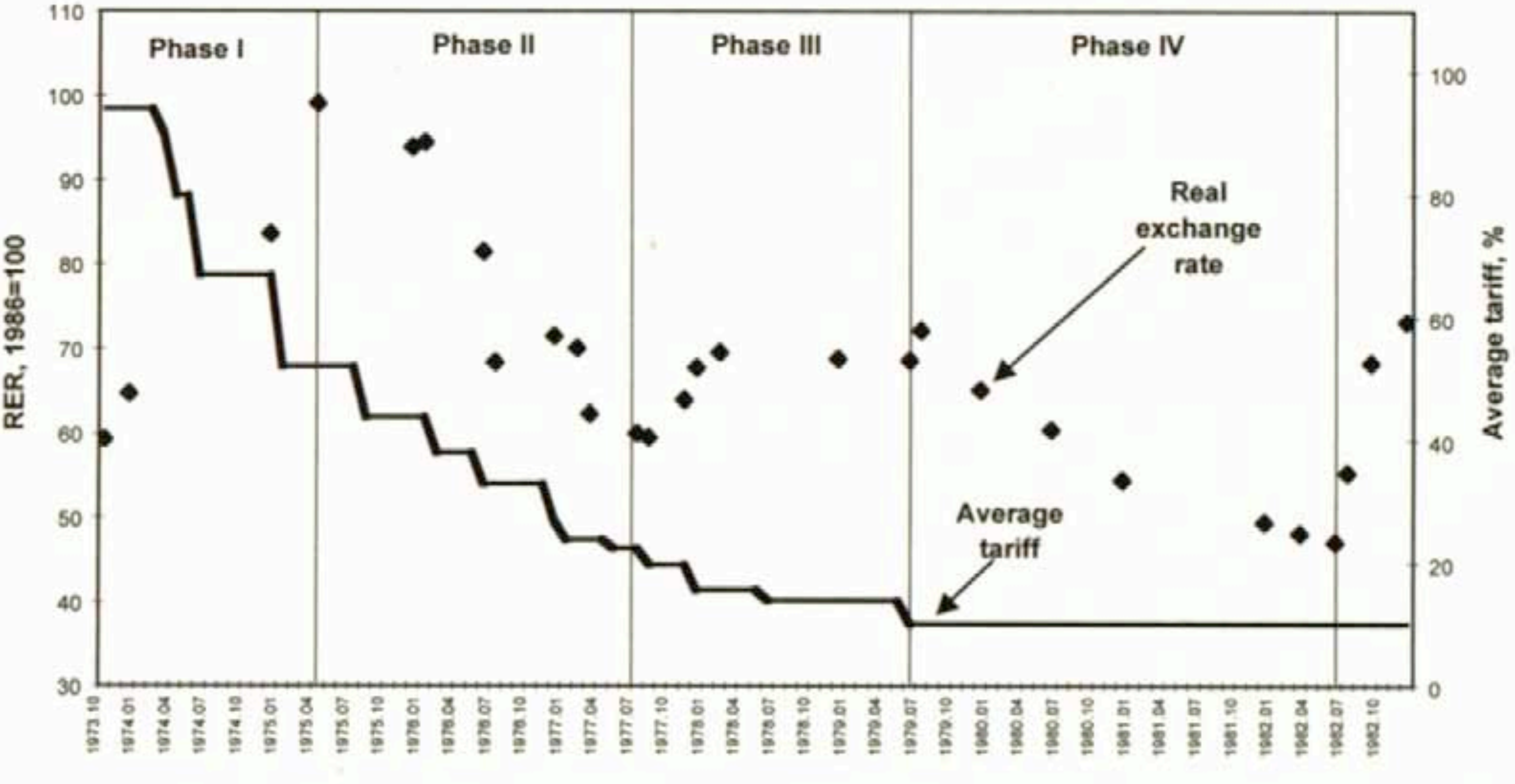

Fig. 3.1. Average tariff and real exchange rates, 1973–82. (Data from Ffrench-Davis 1984 and tables 3.1 and 3.2 in this volume.)

strong impact of this rapid liberalization, unexpected because it contradicted repeated official statements that the exchange rate would "indissolubly" compensate for the dismantling of tariffs.[9] The net result of tariff reforms in phase 2 was a rapid increase in nontraditional imports, particularly nonfood consumer goods.

In phase 3, which lasted until mid-1979, when the nominal price of the dollar was frozen, the exchange rate was periodically adjusted to compensate for tariff reductions, as can be seen in column 2 of table 3.2. Consequently, at the end of phase 3 the average cost of the import dollar was about the same as at its beginning. Naturally, products that were relatively more protected at the start of phase 3 lost their privileged position as customs duties converged toward a uniform 10 percent. These changes occurred in an economy growing more sensitive to the evolution of the international economy, including a constantly rising import coefficient. The average tariff had dropped from 94 to 10 percent during these three phases (and nontariff restrictions had disappeared); while the real exchange rate at the end of the process was only 16 percent above the price at the outset of the reform. Exports also benefited from the broadening of the range of imported inputs, then either liberalized or subject to a uniform tariff. Substitutors, on the other hand, had to compete with imports that on average were 34 percent cheaper than in late 1973.

Finally, in phase 4 the real exchange rate was revalued steadily. This appreciation was a consequence of the fixed nominal rate and a domestic rate of inflation higher than the international rate during the three years in which the exchange rate remained frozen. In the end, foreign currency finished 21 percent cheaper than at the beginning of the reform, while average tariffs were eighty-four points lower. In June 1982, this phase ended with an abrupt devaluation.

In summary, import policy took shape with successive official announcements, with each one of them presented as the final one. Thus, the policy evolved from a moderate opening to trade, explicitly declared to be consistent with the process of Andean integration, to a sharp, across the board trade liberalization. As for the supposed compensatory role of the exchange rate, the facts show that in general the policy did not fulfill this function as it should have according to the assumptions of the economic model. Therefore, an outcome that differed so much from that expected by the economic team is not surprising.

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9. In this phase, Chile left the Andean Pact. As a result, producers of importables faced less Andean competition while exporters lost their significant advantages in that market.

Import Composition

The drastic changes in the structure and level of protection had a significant impact on the composition of imports. As could be foreseen, consumer goods, which had previously been the most restricted category, were the most favored by across the board tariff liberalization. Within this category, imports of nonfood consumer goods were the items that showed the greatest growth.

Many variables other than trade policies affected the behavior of imports. Among the most significant variables were the sharp contraction in aggregate demand in 1975–76 and the recovery in 1977–81, the low investment ratio during nearly the entire liberalization period, and the rise in oil prices.

Between 1970 and 1981, total imports increased by 127 percent in real terms, as shown in table 3.3.[10] If purchases of oil and lubricants are subtracted, the increase is 104 percent. We must keep three factors in mind. First, the increased oil price (along with a drop in domestic production) was for Chile a permanent feature that required the country to generate additional resources to meet the greater expenses, either by reducing other imports or by expanding exports. Second, until 1981 imports of equipment and machinery, as a share of GDP, were significantly below 1970 levels and insufficient to recover historical growth rates. Third, GDP per capita barely increased 10 percent in 1970–81, while imports other than equipment and machinery per capita grew by 115 percent between 1970 and 1981 (table 3.3).

This outcome was predictable given the drastic import liberalization. In fact, increased imports were not a response to an income effect, as per capita output was practically stagnant, but were predominantly due to the liberalization program and exogenous changes in the supply and demand of importables (e.g., oil prices and changes in income distribution).

Different import categories behaved heterogeneously. The influence of liberalization can be observed mainly in nonfood consumer goods, where the greatest number of "new" nontraditional imports are concentrated. Purchases of nonfood consumer goods increased by 534 percent between 1970 and 1981 (and by 518 percent in 1973–81).

The share of machinery and equipment in total imports dropped from 21 to 11 percent, and their participation in GDP fell by one-tenth between 1970 and 1981, with an even more noticeably lower share in the intermediate years. This drop reflects the lack of productive investment in the period (see chaps. 1 and 2).

10. Since 1973 presents significant distortions, in table 3.3 I shall use the figures for 1970, which was considered a relatively "normal" year.

TABLE 3.3. Main Imports of Consumer Goods and Total Imports, 1970, 1980, 1981 (U.S.$ millions in 1977)

	1970	1980	1981	Percentage Change, 1970–81
Confectionery items	0.2	8.2	10.5	5,150
Leather and fur manufactures	1.3	9.0	17.5	1,246
Alcoholic beverages and cigarettes	1.1	22.8	27.5	2,400
Carpets, clothing, knitwear, textiles, and fabrics	24.8	171.9	271.6	995
Photographic and cinematographic products	8.0	17.4	25.2	215
Footwear, hats, and umbrellas	2.1	24.0	43.3	1,962
Musical and optical instruments	4.4	18.1	28.7	552
Toys and recreational goods	3.5	32.0	42.4	1,111
Processed foods from cocoa, meat, shellfish, vegetables, and market produce	5.3	34.6	41.3	679
Perfumery and cosmetics	0.1	13.7	19.6	9,500
Television sets	0.7	49.0	66.2	9,357
Radios	4.7	46.0	45.8	874
Cars and motorcycles	19.5	144.4	263.9	1,249
I. Total main nontraditional consumer imports	75.7	591.1	902.6	1,093
II. Wheat, maize, and sugar	43.6	309.9	262.1	757
III. Fuels and lubricants	118.0	666.9	689.5	484
IV. Other consumer and intermediate goods	1,155.5	1,561.2	1,714.3	48
V. Transport equipment	157.4	317.5	395.8	152
VI. Other capital goods	408.6	376.6	480.6	18
Total imports	1,959	3,823	4,445	127

Sources: National Customs Authority for 1970 and import registers of the Central Bank of Chile for categories II, III, V, and VI in 1980 and 1981.

All imports were directly affected by liberalization. Thus, due to a reversal of the import substitution of final products, a reduction of demand for intermediate goods took place. At the same time, reduction of national integration requirements for industrial activity caused an additional increase in the share of imported components in consumer goods in which substitution survived. This occurred in the auto industry, for instance. Consequently, the structural changes in the pattern of production means that the net expenditure in foreign currency involved in these "new" imports was less than their gross value. Likewise, the gross industrial production figures tended to overestimate the level of domestic activity due to the falling integration of domestic inputs.[11]

Conscious of the limitations of the figures, table 3.3 shows the groups of consumer items (food and nonfood) that increased most between 1970 and 1981. The thirteen groups disaggregated in this table

11. This is the main source of overestimation of GDP in the national accounts calculated with a fixed matrix. See Marcel and Meller 1986 and Scherman 1981.

cover 50 percent of all consumer goods imports in 1981. During the eleven-year period they grew by 1,093 percent (i.e., twice the increase in fuels) while all other imports expanded by 62 percent. As can be seen, most of these nontraditional imports were items that had traditionally been considered "dispensable" or "luxury" goods. In several cases, a variety of these new imported items were not locally produced, even though they did replace similar domestically produced items. There was, then, a significant diversification in the composition of consumption.

The consumption of goods whose imports grew most significantly was concentrated among high-income groups. Naturally, this phenomenon was related to the worsening of income distribution, although this effect was magnified by the fact that consumption by income bracket is more concentrated for importables than for total consumption.

Undoubtedly, the low-income sectors were able to buy new varieties of consumer products, but these purchases were bound by their limited and declining earnings. According to family budget surveys conducted in Santiago by the National Bureau of Statistics, families in the upper quintile increased their share of total consumption from 44.5 to 51.0 percent between 1969 and 1978, while families in the lowest quintile decreased their share from 7.6 to 5.2 percent (see chap. 9). The 1978 survey also reflects the concentration of the consumption of nontraditional imports that year (see table 3.4).

In eleven of the thirteen groups of importables included in table 3.4, the richer quintile consumed a higher percentage than its share in total expenditure (51 percent in 1978). The two groups in which this richer bracket purchased proportionally less than its average include "inferior goods" (negative income elasticity) for the higher income levels. For example, as income rose purchases of black-and-white television sets were replaced with purchases of color televisions, and transistor radios were passed over in favor of stereo sets and tabletop radios.

Overall Effects of Trade Liberalization on Industry

Evaluating the effects of import liberalization is a complex task. First, the effects were significantly different in each phase. Second, many other important changes took place simultaneously. On the one hand, there was a drop in aggregate demand, wages, and investment and a rise in unemployment; these factors strongly influenced the nature of the adjustment process. On the other hand, export expansion, which began before the impact of liberalization was substantial, contributed to the recovery of economic activity and offered opportunities for investment in the production of exportables.