THE POLITICAL ECONOMY OF UNILATERAL TRADE LIBERALIZATION: THE CASE OF CHILE

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ABSTRACT

Chile has become a model for reforming economies throughout the world. The purpose of this paper is to analyze the political and economic circumstances surrounding Chile's unilateral trade liberalization during five stages (covering the period 1974-1990s), each being characterized by different combinations of compensation schemes that were used to raise support and reduce opposition to the reforms. In less than four years (1975-1979) Chile eliminated all quantitative restrictions and exchange controls, and reduced import tariffs from an average in excess of 100% to a uniform 10% tariff. Subsequently, the tariff was temporarily raised to 35% in the aftermath of a severe economic crisis (1983-1984), but was then reduced to 11% by 1991. This liberalization was implemented simultaneously with other reforms, including an effort to eliminate a stubborn inflationary process, financial reforms that ended decades of financial repression, and a massive privatization program. We investigate the role played by ideas, interests and institutions. More specifically, we examine the role played by the "reform team," investigate some of the distributive consequences of the reforms, and analyze the mechanisms the government used to maintain a minimum level of support for the liberalization process. A recurrent question is whether authoritarian governments are sensitive to political considerations when implementing major policy changes. We also present econometric results obtained by using household-level survey data to analyze the effects of trade liberalization on Chile's unemployment. We conclude that during the 1970s and afterwards the Chilean authorities relied heavily on coalition building and on compensation mechanisms in order to increase the political support for the reforms.

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I. Introduction

Chile has become a model for reforming economies throughout the world. Policy-makers, academics, and consultants in Latin America, Eastern Europe, South Asia, and Africa are analyzing the Chilean experiment to get insights on "how" to reform their economies. Yet when Chile launched an ambitious market-oriented program under the aegis of a military dictatorship in 1974, observers throughout the world were openly critical. Chile's economic reforms have been looked at with optimistic interest only in recent years, under the light of the success of the reforms: economic growth has averaged almost 7 percent per year for more than a decade, the annual rate of inflation has declined to around 6 percent, and unemployment is hovering above 5 percent of the labor force -- see table 1.[1]

The purpose of this paper is to analyze the political and economic circumstances surrounding Chile's unilateral trade liberalization, which was implemented simultaneously with other reforms, including an effort to eliminate a stubborn inflationary process, financial reforms that ended decades of financial repression, and a massive privatization program. In less than four years Chile dismantled quantitative restrictions and replaced a surrealistic tariff structure (with an average tariff in excess of 100%) with a uniform 10% tariff. Following Bhagwati (1988), we investigate the role played by ideas, interests and institutions.[2] More specifically, we examine the role played by the "reform team," investigate some of the distributive consequences of the

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[1] On the Chilean reforms see Harberger (1985), Edwards (1985), Edwards and Edwards (1991), and Bosworth, Dornbusch and Labán (1994).

[2] Bhagwati (1988, 17) was one of the first contributions by economists that argued that protectionism was the result of a variety of forces: "Profound commitments to policies are generally due to a mix of ideological factors (in the form of ideas and example), interests (as defined by politics and economics), and institutions (as they shape constraints and opportunities)."

reforms, and analyze the mechanisms the government used to maintain a minimum level of political support for the liberalization process. A recurrent question is whether authoritarian governments -- such as the Pinochet dictatorship that ruled Chile during 1973-1989 -- are sensitive to political considerations when implementing major policy changes. We also present econometric results obtained by using household-level survey data to analyze the effects of trade liberalization on Chile's unemployment.

The rest of the paper is organized as follows: Section II presents an overview of Chile's liberalization, sketching the initial conditions, and tracing the evolution of trade policy from 1974 to the 1990s, while distinguishing among five stages of the process of trade liberalization. Section III focuses on the role of ideas, beginning with a brief discussion of analytical aspects associated with the dynamics of economic reforms in general, and with some key practical issues related to the speed and sequencing of economic reforms, and the post-reform tariff structure. We then discuss the ideas of the change team, their original plan of reform and its actual implementation, and, finally, we review the views of dissenters in the context of Chile's restricted market for ideas. After a brief review of analytical issues related to the role of interest groups in general, and after providing a taxonomy of Chilean interest groups, section IV analyzes the application of compensation mechanisms that were used by the authorities to raise support for and reduce opposition to the reforms. Section V presents the econometric results regarding the employment effects of trade liberalization. Section VI concludes by arguing that Chile has begun to abandon its staunchly pro-unilateralism position, and is now flirting with regionalism.

II. Five Stages of Trade Liberalization in Chile, 1974-1990s

On September 11, 1973, after three years of a democratically-elected socialist administration led by President Salvador Allende, the military staged a coup and took over Chile's government. At the time of the military coup, import tariffs averaged 105 percent and were highly dispersed, with some goods subject to nominal tariffs of more than 700 percent and others fully exempted from import duties. In addition to tariffs, a battery of quantitative restrictions were applied, including outright import prohibitions, prior import deposits of up to 10,000 percent, and a distortionary multiple exchange rate system consisting of fifteen different rates (see Table 2).

Despite a temporary and moderate reversal in the midst of a severe balance of payments crisis during 1983-1985, Chile has been able to sustain a continuous process of unilateral liberalization since 1974. This achievement becomes even more interesting when one considers that in the meantime Chile experienced the breakdown of its democratic system, sharp business cycles, several dramatic shifts in other aspects of economic policy, a return to democratic government, and important changes in the world trading system. From a political economy perspective, it is useful to distinguish among five stages in Chile's unilateral trade liberalization; each stage being characterized by the use of different types of "compensation schemes," as will be shown in Section IV below.

In terms of policies, the first phase (1974-1978) was characterized by a dramatic reduction and simplification of its trade barriers, which was part of a comprehensive program of economic stabilization and restructuring. The second stage (1978-1982) was characterized by a change in the stabilization program, and by a build-up of a significant degree of real exchange rate overvaluation. The third stage was the temporary reversal phase (1983-1985) that occurred when Chile faced a deep economic crisis. The fourth period covers the resumption of unilateral liberalization in the context of a speedy economic recovery and the beginning of the end of the military government (1985-1990). The fifth stage began with the transition to democracy and the tariff reduction of 1991, and may be ending with Chile′ s turn towards preferential trading arrangements (PTAs), high capital inflows (at least through 1997), and vigorous economic growth.

Stage I: 1974-1979

In October 1973, the Minister of Finance stated that Chile's "best prospects for growth are in opening to international competition" (Méndez 1979, 63-64). Initially, however, the authorities had no precise idea about how deep and how fast the liberalization should be. In fact, only after Chile withdrew from the Andean Pact in December of 1977, did the chief economic strategist, Minister Sergio de Castro, announced that the final goal was to reduce tariffs to a uniform rate of 10 percent by mid-1979. In explaining this change in tariff policy, de Castro pointed out that the prevailing differentiated tariff structure of rates between 10 percent and 35 percent generated an unjustifiable discriminatory situation.

Table 3 contains the itinerary of import tariff reductions for 1974-1991, and shows that the liberalization was actually somewhat abrupt during the first phase (1974-1979). By June 1976, the average tariff was 33 percent, representing a reduction of more than 60 percentage points from the average tariff of December 1973. This achievement was particularly impressive, since quantitative import restrictions had been eliminated by August 1976 (see Table 2). By

June 1979, when the first phase of the trade reform came to an end, all items, except automobiles, had a nominal import tariff of 10 percent. The impact of this liberalization phase was different across sectors. Table 4 shows the evolution of the rate of effective protection for eighteen industries within the manufacturing sector during 1974-1979. Clearly, both the level and dispersion of the effective rates of protection were reduced as the reforms progressed.[3] By June 1979, the average effective tariff was 13.6 percent, and the range between the highest and lowest effective tariffs was only six percentage points. Another notable consequence of the reform was that it increased the level of effective protection granted to agriculture. Historically, through the imposition of price controls on agricultural products and high import tariffs on inputs, most crops had suffered from a substantial negative rate of effective protection. In 1974, for example, the agricultural sector had a negative average rate of effective protection of 36 percent.[4]

This initial phase of trade liberalization was supplemented by an active exchange rate policy aiming to maintain a competitive real exchange rate. In fact, the reduction of trade

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[3] The effective rate of protection is a measure of the relative degree of inefficiency of domestic production relative to international production. A positive value means that domestic value added for that particular activity exceeds value added at international prices. The effective tariff for good $i(\gamma_i)$ is computed in the form of

$$\gamma_i = (t_i - \sum a_{ij}t_j)/(1 - \sum a_{ij}),$$ where t_i is the nominal tariff, a_{ij} is the input/output coefficient between input j

and good I, and t_j is the nominal tariff on input j. Notice that if the good and *all* inputs have the same nominal tariff, then the effective and nominal rates of protection are the same $(\gamma_i = t_i)$. It should be noted that from a general equilibrium perspective the usefulness of the concept of effective rates of protection is quite limited (see Bhagwati and Srinivasan 1979).

[4] On the degree of effective protection in Chile's agriculture sector prior to the reform see Varas (1975). Behrman (1976, table A.3) lists effective rates of protection for products within the agricultural sector ranging between -11 and -39 percent in 1967. Alternative measures can also be found in Balassa et al. (1971).

barriers and the deterioration of Chile's terms of trade after 1974, *required* a depreciation of the equilibrium real exchange rate. The depreciation of the real exchange rate was first achieved via the maxi-devaluation of October 1973, and then was maintained by a crawling exchange rate system, which lasted until January of 1978.[5] The importance assigned by the government to a "depreciated" real exchange rate was clearly articulated by General Pinochet in a 1976 speech (Méndez 1979, 195): "We shall continue to encourage nontraditional exports .... The Minister of Finance will announce the manner in which the exchange rate shall be established in order to guarantee a viable and permanent value for foreign currency."[6] At the end of 1976, the real effective exchange rate was almost 150 percent more depreciated than in the third quarter of 1973. In an attempt to break inflationary expectations, the peso was revalued in June 1976, and again in March 1977. In the second half of 1977, to compensate partially for the effects of the new rounds of tariff reductions, the rate of nominal devaluation with respect to the US dollar was once again increased.

Stage II: 1979-1982

A change in the stabilization program took place in 1978, when the exchange rate became the main anti-inflationary anchor. The rate of devaluation was announced for a year and was

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[5] The initial maxi-devaluation responded in part, to the need to avoid an almost imminent balance of payments crisis. As the tariff process proceeded the crawling peg tried to (approximately) maintain the high level of the real exchange rate.

[6] In fact, the exchange rate played a crucial role in the government's explanation of the negative effects of protectionism during the previous decades. For example, according to de Castro:

> "The relatively forced industrialization of the country was obtained through various mechanisms. One of these was the foreign exchange rate policy. From 1939 on, the exchange rate was maintained artificially low.... The exporting sector lost all possibility to export because ...[with a low] exchange rate ... they could not manage to cover their local production costs" (Méndez 1979, 201).

preset at a rate below ongoing inflation, and in 1979, the exchange rate was fixed to the dollar. Between 1978 and 1982, and partially as a consequence of the new exchange rate policy, a significant degree of real exchange rate appreciation developed. This appreciation became increasingly unsustainable, and a major balance of payments crisis erupted in 1982 . The country ran out of reserves, a major devaluation was implemented, and numerous firms and banks went bankrupt. As a consequence, unemployment skyrocketed, and GDP declined by over 14 percent in 1982 alone (see Edwards and Edwards 1991).

Stage III: 1983-1985

The third phase of Chile's trade reform saga encompasses the period between March 1983 and June 1985, when the uniform tariff was raised from 10 percent to 35 percent as part of a series of measures designed to speed-up the adjustment process (see Table 3). In addition, the government re-introduced price bands for three commodities -- wheat, sugar and edible oil -- in 1983, which were meant to provide, on average, a rate of nominal protection equivalent to the uniform tariff rate.[7] Between 1982 and 1983, Chile experienced a severe economic contraction, which was accompanied by a fast adjustment of its current account (see Table 1). Unlike previous historical experiences with increases in trade protection to correct external imbalances (such as during the 1930s), this time the tariff hikes (no quantitative restrictions were imposed) were short-lived, but the price bands have been maintained until today.

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[7] Price bands for wheat were originally introduced in 1977, but in 1978, the president of the National Society of Agricultural Producers (SNA, in Spanish) asked the government to eliminate them, because the international price of wheat was high and the price bands did not act as an instrument of protection under those circumstances. Finally, the price bands were "legalized" on June 30, 1986, after the implementation of Law #18,525, article 12. See Chacra and Jorquera (1991, 3).

Stage IV: 1985-1990

The process of unilateral liberalization resumed on June 1985, when the uniform tariff was reduced to 20 percent. Later, in May 1988, the tariff was again reduced to 15 percent. This was the last trade policy reform conducted by the military government, since Pinochet lost the referendum or plebiscite vote of 1988. Democratic elections took place in 1989, and the administration of Patricio Aylwin came to power in March 1990. During this time, and especially between 1988 and 1990, a high degree of uncertainty reigned over the future economic policies of a democratically elected government. Consequently several important economic policy measures were undertaken, including the establishment of an independent Central Bank, which aimed to reassure markets that a dramatic change in economic orientation could not take place after the political transition.[8]

Stage V: 1991-?

A further reduction of the uniform tariff, from 15 to 11 percent took place on June 1991, thus consolidating the trade liberalization that had survived the economic crash of 1982-83, and the transition to democracy of 1988-90. Since mid-1991, Chile began to implement a new trade strategy emphasizing PTAs. The most intense domestic debates have focused on Chile's negotiation of a free-trade agreement with Mercosur (implemented in 1997), and its potential accession to the North American Free Trade Agreement (NAFTA). A number of Chilean analysts (especially economists based at the *Universidad Católica*) and more recently the National Society of Agricultural Producers (SNA, in Spanish) have supported the idea of

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[8] The Central Bank Autonomy Act was implemented on April 1990.

unilaterally reducing the uniform tariff to around 7 or 8 percent. This renewed interest in unilateral liberalization has been driven by three inter-related factors: First, there is a growing concern that the pursuit of PTAs will generate a significant degree of trade diversion. Second, the producers of traditional agricultural products are concerned about the real appreciation of the currency, *and* about the increased competition from Argentine and Brazilian exports of wheat and edible oil, since the associate membership agreement with Mercosur stipulates the elimination of the price bands in approximately 18 years. Third, the PTAs imply that the "tariff structure has again become differentiated in the range of 0-11 percent, depending on the country of origin [of the imports]..." (Corbo 1997, 76). We will return to the prospects for a continuation of unilateral liberalization in Chile in the concluding remarks at the end of the paper.

III. The Role of Ideas

1. Dynamics of Reform

Bates and Krueger (1993, 454) wrote that, "[t]here is no recorded instance of the beginning of a reform program at a time when economic growth was satisfactory and when the price level and balance of payments situations were stable. Conditions of economic stagnation...or continued deterioration are evidently prerequisites for reform efforts." Likewise, Rodrik (1994, 63) explains that, "The reasons for the free trade bandwagon are more or less unique and derive from the intense, prolonged macroeconomic crisis that surrounded developing countries during the 1980s... which overshadowed the distributional considerations...."[9]

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[9] For additional arguments in favor of the crisis hypothesis, see Drazen and Grilli (1993), Williamson and Haggard (1994), Tornell (1995), and Bruno and Easterly (1996). For an skeptical view, see Rajapatirana et al. (1997), who show that historically many macroeconomic crises in Latin America have resulted in the "tightening"

According to this "crisis hypothesis," in the midst of an economic crisis, social scientists are called by politicians to find a way out of the crisis. Based on the Anglo-Saxon economic tradition and consistent with the views of the multilateral institutions, the incoming *technopols'* ideas become highly influential.[10] Proponents of the protectionist development strategy try to dismiss the new approach as being foreign and/or imposed by the multilateral institutions; at the same time, the *technopols* try to persuade politicians and the public that their program is based on sound scientific principles, supported by international empirical evidence. During the implementation stage, the *technopols* usually find that the realities of politics conflict with the simple world of economics. Their ability to understand political trade-offs, and to design politically viable strategies that rely on adequate compensation mechanisms, may determine the fate of the reform effort.

As the crisis subsides, efforts by the opposition to stop the modernization process can be successful if the reforms have not generated sufficient improvement in economic growth, lower inflation, higher real wages, and lower unemployment. Pressures to reverse the reforms can emerge in democratic and authoritarian settings. In some cases the "populist temptation" is

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of trade policies. Support from the multilateral institutions -- either in the form of technical assistance or through the provision of funds -- may help the reform effort, once it has been launched. However, there is significant evidence that the multilaterals -- and mostly the IMF and the World bank -- have not usually played a fundamental role in the initiation of reforms (see Edwards 1997a). Moreover, Haggard and Webb (1994, 5) argue that there are no recorded reform episodes since the mid-1970s that have failed exclusively due to a lack of financial support from the multilateral financial institutions.

[10] Domínguez (1997, 7) defines *technopols* as follows: "Technopols are a variant of technocrats. In addition to being technocrats... technopols are political leaders (1) at or near the top of their country's government and political life (including opposition political parties) who (2) go beyond their specialized expertise to draw on various different streams of knowledge and who (3) vigorously participate in the nation's political life (4) for the purpose of affecting politics well beyond the economic realm and who may, at times, be associated with an effort to "remake" their country's politics, economics, and society. Technopols so defined may operate in either authoritarian or democratic regimes."

strong enough to bring the reforms to a standstill; in others, reformers are able to consolidate the reforms.[11] In order to regain public support, the authorities may reduce the pace of reforms, or may relax the public sector budget constraint to face a political challenge, such as a mid-term election or a plebescite in the case of an authoritarian ruler seeking to enhance its legitimacy.[12]

2. Speed, Sequencing, and Protective Structure

The role of "transition costs" has been at the çenter of discussions about the optimal *speed* of trade liberalization. Analysts have argued that a gradual liberalization is preferable to a big-bang approach, because gradual reforms give time for firms to restructure their operations, resulting in lower unemployment, fewer bankruptcies, and therefore, less political opposition to the liberalization program than under a fast liberalization. Other analysts have argued that slower reforms tend to lack credibility, thus inhibiting serious restructuring.[13] Whether trade reform generates an increase in aggregate unemployment is an empirical issue. A World Bank study on liberalization episodes in 19 countries led by Michaely et al (1991) suggests that even in the short-run, the employment costs of reform can be small; although losing industries will release workers, export-oriented sectors will tend to create employment opportunities.

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[11] Boeninger (1992, 275) coined the term "populist temptation," referring to the short-term incentive faced by fiscal and monetary authorities to finance public expenditures by excessive borrowing and/or issuing currency. For detailed analysis of populist macroeconomic policies see Dornbusch and Edwards (1990).

[12] In Chile, plebescite votes took place in 1980 and 1988. The former was "noncompetitive," and was convened at the peak of an economic boom. Nevertheless, current expenditures grew at an average annual rate of 11 percent between 1979 and 1981 (Fontaine 1996, 14).

[13] See, for example, Rodrik (1989), Calvo (1989), and Martinelli and Tommasi (1994).

The *sequencing* of components of reform programs was first addressed during the 1980s, in discussions dealing with the experiences of Argentina, Chile and Uruguay. It is now generally agreed that the fiscal accounts have to be under control at the time that a major structural reform effort is launched, and that financial reform should only be implemented once a modern and efficient supervisory framework is in place. The debate over the order of liberalization of the trade and capital accounts revolves around the behavior of the real exchange rate. The liberalization of the capital account can bring an appreciation of the real exchange rate, which sends the "wrong" signal and frustrates the reallocation of resources demanded by the trade reform.[14] McKinnon (1982) and Edwards (1984) argue that the effects will be particularly serious if the transition period is characterized by "abnormally" high capital inflows that result in temporary real appreciations. According to this view, only after the new allocation of resources is consolidated should the capital account be liberalized.[15]

Some authors have argued recently that labor market reform, particularly the removal of distortions that discourage labor mobility, should precede the trade reform (as well as the relaxation of capital controls). Edwards (1988; 1995, 122) argues that trade liberalization under distorted labor markets can even generate overall welfare losses. Labor market reform can also have political ramifications, because owners of capital that would otherwise oppose a trade reform, may support it if trade liberalization comes with more flexible labor market regulations,

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[14] This would be the case if the opening of the capital account is done in the context of an overall liberalization program, where the country becomes attractive for foreign investors and speculators. See McKinnon (1991).

[15] Lal (1985) presents a dissenting view. Hanson (1995) has argued that under some circumstances the capital account should be liberalized early on.

but unions in the formal sector will usually oppose labor market reforms that reduce their political and economic influence.[16]

A common feature of protected economies is that import tariffs and effective rates of protection are dispersed.[17] Harberger (1991) has argued that differentiated tariffs will always be subject to greater interest-group pressures than a uniform tariff structure. Firms, or business associations, will lobby for high tariffs on their goods and for exemptions for their imported inputs. Different arguments will be used, including the fact that a particular sector is "strategic," or that it creates employment, or that it allows the country to absorb advanced technology, or that it is important to safeguard a country's "national security." These pressures can be ameliorated by implementing a uniform import tariff, with no exemptions. Harberger (1991, 19) has argued that uniform tariffs "provide a natural guarantee against the huge efficiency costs... in the exaggerated rates of effective protection that flow from grossly differentiated tariff structure. What is the key political economy tactic that the strategy involves? Putting each individual protectionist interest group in the defensive."[18]

Most of the issues identified by the political economy literature -- speed, sequencing, unemployment, and real exchange rate behavior, among others -- played an important role in the unfolding of the Chilean trade liberalization of 1974-1990s. In the end, both the policies as well

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[16] In other words, the coupling of trade and labor reforms transforms an inter-sectoral distributive conflict (as would be the case in a specific factors economy contemplating only a trade reform) into a inter-factor dispute.

[17] See Balassa and Associates (1971) for estimates of sectoral effective rates of protection in several developing countries during the 1960s.

[18] From an efficiency point of view, however, it is more difficult to defend a uniform tariff. Using an intertemporal general equilibrium approach, Edwards (1997b) shows that the optimal tariff structure would depend on a number of variables, and would only by chance be characterized by a uniform nominal tariff.

as their effects were significantly different from what Chilean policy-makers and other observers had anticipated.

3. Ideas and the Change Team

Bates and Krueger (1993, 456) argue that one explanation for the failure of interest groups to derail recent economic reforms is that, "in the context of comprehensive economic policy reform, it is difficult for particular groups to calculate where their interests lie. Ideological struggles therefore can outweigh competition among organized interests as a determinant of policy change." Williamson (1994) similarly argues that the probability of success of the reform effort will be higher with, "The existence in government of a team of economists (headed by a technopol...) With a common, coherent view of what needed to be done and commanding the instruments of concentrated executive authority" (p. 26).

In Chile, the change team was composed mostly of economists trained at the University of Chicago during the 1960s and early 1970s.[19] These economists, many of whom had joined the faculty of the Catholic University upon returning from Chicago, believed that excessive government intervention, high inflation, and rampant protectionism were at the heart of Chile's historical lackluster economic performance. Although they had produced some of the best applied research in Chile, for years their views were dismissed by the political establishment as mildly amusing, and not worthy of being taken seriously.

[19] In 1956, the University of Chicago and the Catholic University of Chile signed an agreement aimed at training Chilean economists in Chicago. See Valdés (1995).

A prominent group of "Chicago boys," including Sergio de Castro and Sergio de la Cuadra -- both would later become Finance Ministers under Pinochet -- had participated in the design of the economic program of conservative presidential candidate Jorge Alessandri in 1970.[20] Three years later, in the midst of the *Unidad Popular* economic crisis, this group began to prepare a new economic plan for an eventual post-socialist administration. Their work was funded by some private sector foundations, and carried out under strict confidentiality. By September 1973, the group had already produced a draft of a document titled *"A Program for Economic Development,"* which proposed what at the time were considered to be radical economic reforms.[21] In the weeks preceding the *coup d'état,* a copy of the Program had been made available by the group's coordinator to the Navy high command. In retrospect, it is not surprising that when Admiral Lorenzo Gottuzzo was named the Junta's first Finance Minister he asked some of the Chicago boys to become his advisers. At the same time, the new Minister of Planning, a retired senior navy officer, also hired some of the Chicago boys as advisors. Others joined the staff of the Central Bank, which without international reserves faced the tremendous challenge of disciplining monetary policy and taming an inflationary process approaching the four-digit level.

Hence the Chicago boys' initial participation in the military government was restricted to advisory roles. The military, with a nationalistic doctrinal perspective, naturally gravitated towards more traditional views, and contacted some respected "wise men" to offer them

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[20] Alessandri lost the elections to Marxist candidate Dr. Salvador Allende by merely 33,000 votes.

[21] The document became known among the members of the group as "the brick" (*el ladrillo*, in Spanish), a reference to the size of the manuscript.

influential positions within the regime.[22] The views of these individuals were more moderate than those of the Chicago boys; they believed in gradual corrections of the distortions, in maintaining a prominent role for the state as a producer, and in maintaining moderate levels of protectionism. As Garretón (1986) and Valdés (1995) have pointed out, it was only slowly that the Chicago boys views became dominant within the Pinochet administration. This increase in influence was the result of two factors: First, the original gradualist approach to solving the *Unidad Popular* imbalances, especially inflation, were not yielding the desired results. Second, in the middle of the crisis, the Chicago boys' radical, but internally coherent policy proposals, became more attractive. In April 1975, a breakthrough took place. Jorge Cauas, a prestigious economist who had been Director of the World Bank's Research Department, and who in many ways was an "honorary Chicago boy," was named Minister of Finance. At the same time, Sergio de Castro, the dean of the Chicago group became Minister of Economics. Under their leadership the gradual approach to stabilization and reform came to an end, and what came to be known as "shock therapy" was applied. In a matter of two years inflation was reduced drastically, the economy opened to international competition, and a major privatization program launched. During 1976-1979, after two years of recession, the Chilean economy grew at over 7 percent per annum, and the views of the "Chicago boys" seemed vindicated. The boom years lasted through 1980-1981, but in 1982-1983 the economy plummeted into a crisis as a result of the rapid

[22] Several economists belonging primarily to the Christian Democratic Party (DC) were approached by Admiral Gotuzzo, who offered them jobs in his Ministry of Finance. Some of these wise men, such as Sergio Molina and Raul Saez had served under the Frei government of 1964-1970. Carlos Massad, a more moderate Chicago graduate and former (and current, since 1997) president of the Central Bank was also approached. See Valdés (1995, 17).

appreciation of the real exchange rate, high real interest rates, and a hostile external environment -- see Table 1.

Although the original reform program of the Chicago boys was seen as revolutionary in 1973, from today's perspective it looks rather tame. The original document was divided into two parts: diagnosis and policy recommendations. The second part, which is of greater interest for our purposes, dealt with eight policy areas: decentralization, international trade, prices, monetary and fiscal policies, taxation, capital markets, social security, and income distribution. In addition, it provided some recommendations with respect to unemployment, education, foreign investment, agriculture, and industrial policies.[23]

4. From Plan to Implementation

Trade liberalization played a prominent role in the Chicago boys Program of 1973. The document focused on two main aspects of Chile's trade-related policies: (1) the traditional "non competitive" level of the real exchange rate; and (2) the resource misallocation caused by the country's protective structure. Although both of these subjects had been extensively documented, the Program correctly pointed out that during the *Unidad Popular* the situation had worsened significantly.[24]

In the order of appearance in the document, the Program made the following specific proposals regarding trade policy:

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[23] In September 1973 -- a week after the coup -- the Planning Ministry printed 200 numbered copies. The document was finally published by the *Centro de Estudios Públicos* in 1992.

[24] Harberger (1959), for example, provided early estimates of the effects of Chile's protective structure. See also Behrman (1976) for the Bhagwati-Krueger NBER project on trade regimes.

- **Engineer a real exchange rate depreciation.** It was argued that a more competitive real exchange rate would encourage exports and help avoid the recurrent balance of payments crises that had plagued the country.
- **Implement a crawling peg exchange rate regime aimed at maintaining the real exchange rate at a competitive and depreciated level.** The document deliberately ruled out a flexible nominal exchange rate regime, arguing that it would create unnecessary short-run volatility. It was argued that the level of international reserves should be used as an indicator of "fundamentals" behavior. A rapid loss of reserves would reflect that an "equilibrium" depreciation was warranted. Interestingly enough, an asymmetric approach towards exchange rate adjustment was advocated. It was argued that "an 'excessive' accumulation of reserves would not necessarily be translated into a decline [appreciation] in the exchange rate; it would be preferable to reduce import tariffs..."(p.75).
- **Reduce import tariffs.** A preannounced and programmed tariff reduction was proposed. The new protective structure would be characterized by a new 30 percent uniform import tariff. Four points were made regarding this aspect of the reform. First, the tariff reduction should be undertaken *at the same time* as the real exchange rate depreciation. Second, uniformity was considered essential. This aspect of the reform was rationalized on the basis of the desirability of granting the same degree of effective protection to all activities.[25] Third, it was argued that, although politically infeasible, the ideal would be

[25] The Program incorrectly argued that a uniform import tariff was second best optimal from a welfare perspective.

to completely eliminate tariffs. And fourth, the program pointed out that in order to avoid dumping problems, reference prices would be used to calculate the import tariff. These reference prices would, in turn, be calculated as a three-year moving average of the international price.

- **Eliminate all import licenses and prohibitions.** It was argued that these should be replaced by equivalent import tariffs.
- **Implement export promotion schemes** aimed at offsetting the discriminatory effect of the uniform import tariff.

The Program then argued that these policies would, in principle, create two problems: First, the devaluation required to achieve a more depreciated real exchange rate would provoke inflation. Second, and more serious, it was argued that the tariff reduction would increase unemployment. According to the document, however, this problem could be ameliorated if labor mobility was enhanced.

The program also argued that Chile should negotiate relatively low tariffs in the Andean Pact; if this was not done, it would not be possible to reap the benefits of a more open external sector. It was also argued that, at least in the short- to medium-run, it would be necessary to maintain capital controls to avoid capital flight. Interestingly enough, there was no hint of the possibility that the country could suffer the opposite problem of being flooded with external funds. Finally, the document was not very explicit about the speed of reform. While at one point it said that a uniform 30 percent tariff should be implemented "as soon as possible," elsewhere it states that the tariff reduction should proceed in a "programmed and gradual" fashion.

Finance Minister Gotuzzo announced in January 7, 1974, that, "the study of a complete reform of the tariff schedule requires the collaboration of various groups... the Commission in charge of this project will contact the different organizations of the private sector..." (Méndez 1979, 81). This Commission was known (in Spanish) as the *Comisión de Asesoría de Política Arancelaria* (CAPA) and Dr. Sergio de la Cuadra became its first president. The commission established the basic principles that would guide the liberalization process:

- There was an explicit recognition that reductions in the degree of protection had to be compensated through real exchange rate devaluations.
- International agreements -- including those with the Latin American Integration Association (LAIA) and the Andean Pact would be respected.
- The final tariff structure -- called the "definitive tentative tariff" -- would be comprised of three levels: 25 percent for primary products, 30 percent for intermediate goods and 35 percent for capital goods. The CAPA established that this structure responded to political considerations, and recognized that it was very difficult (if not plainly impossible) to justify it on economic grounds.
- The liberalization process would be carried out gradually, during a 3-year period.

By late 1974, the country had eliminated import licenses, the maximum tariff stood at 140 percent, and the average tariff was 67 percent, down from over 100 percent in September 1973. However, and in spite of the decisions reached by the CAPA, the authorities were still uneasy about the final tariff structure.

At a conference that took place in December 1974, Sergio de la Cuadra, the chairman of the CAPA, disclosed a new proposal (de la Cuadra 1976). This remarkable document recognizes the existence of major political constraints associated with trade liberalization. In the introduction, de la Cuadra stated that "trade liberalization has created a political problem, as long as there are people that gain and people that lose" (p. 81, translated). The author goes on to argue that under this type of situation, members of the bureaucracy -- and especially lower level officials -- become increasingly powerful when they have some discretion in the implementation of general policies. He argues that in designing the new tariff structure, the authorities "should accept the existence of pressure groups...[and should] provide mechanisms that prevent those pressures from becoming mechanisms that prevent the accomplishment of the authorities' goals" (p. 82, translated). Hence, "in the absence of a uniform tariff, it should be recognized that tariffs will be manipulated for protectionist purposes. Thus, it is necessary to establish rules that regulate these manipulations" (p. 88-89, translated). His specific proposal was a tariff structure with a 10 percent mode and a 30 percent maximum nominal tariff. Notice that this proposition is significantly closer to free trade than either what the Chicago boys had originally envisaged in the Program, or what the CAPA had decided to do only a few months earlier. De la Cuadra then argues that this more daring tariff proposal should be compensated with a more depreciated real exchange rate. He goes as far as saying that, "to the extent that it is not possible to devalue the currency, the magnitude of tariff reduction would have to be smaller" (p. 92, translated). With regard to the Andean Pact, de la Cuadra argued that a *fait accompli* strategy would be beneficial; if the new tariff structure were to be implemented rapidly, Chile could then negotiate with the other members of the Pact from a position of strength.

In discussing the design of the Chilean tariff structure de la Cuadra (1976) barely touches on the employment costs of the transition. This reflects a combination of beliefs and political realities. As had been expressed in the Program, the Chicago boys believed that in the context of a flexible labor market, the unemployment costs of a major trade reform would be rather small. One of the early policies of the military regime had been to establish a *de facto* flexible labor market: union activities had been banned, minimum wages had declined steeply, and other labor legislation had been relaxed (see section IV.3 for details). However, opponents of the reforms argued throughout the process that the main effects of this "radical" program were to destroy Chile's industrial base, and to generate unemployment. Naturally, the fact that the rate of unemployment had indeed increased significantly made their argument appealing.[26]

Between 1975 and mid-1977, there were eight rounds of tariff reductions, and in August of that year the average tariff stood at 19.8 percent. The maximum tariff had reached the 30 percent target, and the mode was 20 percent. During this process the authorities faced a number of unexpected developments. First, the extent of political opposition was smaller than anticipated, even when the nature of the political regime was taken into account. This was largely the result of the "compensation mechanisms" approach discussed in greater detail in the subsection that follows. Second, the reform seemed to be bearing fruit faster than anticipated. Exports were growing rapidly and, perhaps more importantly, they were becoming increasingly diversified (see Figure 1). And third, negotiations with the Andean Pact partners were proving tougher than anticipated. This was particularly the case with respect to the Pact's direct foreign

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[26] The most important writings of the reform skeptics were collected in a volume titled *Trayectoria de una crítica* (*Trajectory of a Critique)* and was published in 1982 (Arellano and others 1982).

investment provisions -- the *Acuerdo de Cartagena* (in)famous article 24 -- that greatly restricted the role of foreign ownership in the member countries.

As early as June 1976, then Economics Minister Sergio de Castro expressed Chile's disagreement with the Pact's Article 24. In a speech in Cartagena, Colombia, he said: "we are absolutely sure that in order to attract the investment we require, it is necessary to modify Article 24 and to make it suitably flexible" (Méndez 1979, 206). He added that the only responses Chile had received from its partners were "expressions of goodwill which have never gone any further. Only the firm attitude of the Chilean government has finally achieved the initiation of serious discussions on the modification of Article 24" (Méndez, 1979, 208). But he was wrong. Time passed and no progress was made on this issue. As a result, it became increasingly clear to the authorities that the Pact was a serious obstacle for achieving the military government's goals of integrating the Chilean economy to the rest of the world. In mid-1977, it was decided that the costs of remaining in the Pact greatly outweighed the benefits, and Chile announced its withdrawal. Shortly after, Minister de Castro, by then holding the finance portfolio, announced that the government's final goal was to achieve a uniform 10 percent tariff by mid-1979. He assured the population, however, that as it had been done all along, those affected by these measures would be compensated by real exchange rate depreciations. Specifically, he said:

> "[T]he lower are tariffs the higher should exchange rates be...[A]s a compensation for the tariff reduction corresponding to the current month, we have decided to devalue by 4.3 percent...For the following months the exchange rate adjustment will correspond to inflation in the preceding months, plus an additional amount to compensate for the tariff reduction" (*Boletín Mensual, Banco Central de Chile*, December 1977, p. 1960-61).

5. *Dissenting Views in a Restricted Market for Ideas*

Although traditional democratic channels to express dissenting views had been eliminated after the coup, those intellectually opposed to the market-oriented reforms expressed their views in a variety of ways. In particular, prominent economists associated with the opposition think-tank CIEPLAN, launched a series of attacks against the program.[27] The liberalization process was mainly criticized on three accounts: its excessive reliance on free prices and market forces; the reduced role of the government in economic matters; and the opening of international trade and financial transactions to foreign competition. These criticisms were channeled through articles in weekly magazines, and in more specialized journals. The diffusion of these ideas to a broader public was severely restricted, however. In fact, for a while the authorities did not allow the CIEPLAN group to release its collection of articles in the form of a book amidst the 1982 economic crisis.[28]

The opening of the economy -- including its speed and intensity -- was the subject of some of the most severe criticisms. For example, in October 1976, Ffrench-Davis argued that import tariffs of the order of 65 percent were "decisively moderate for countries of our degree of development." In July 1977, Ffrench-Davis wrote in the weekly *Hoy* that, "a mistaken approach that moves the country excessively towards free trade, means closing some lines of production..." And in February 1978, he said that "the saddest aspect of trade liberalization is that it has been

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[27] During the Pinochet regime the military did not allow open political discussions. As a result, debates on economic policy became a substitute for political discussions. The CIEPLAN economists played an important and brave role in maintaining some sense of perspective in Chile during these years.

[28] Interview with Ricardo Ffrench-Davis, Santiago, Chile, August 17, 1997 (via telephone).

carried out at great speed...," and he argued that the government should "undo the mistakes made...[F]irst, undo immediately part of the trade liberalization...[and] returning to the Andean Pact" (Arellano and others 1982, 349 & 354).

During the late 1970s much of the criticism of the liberalization program was centered on the potential effect of trade reform on employment and social conditions. In July 1978, Foxley wrote in the weekly *Hoy* that, "the rapid reduction of import tariffs...[is one] of the factors that explain the high rate of unemployment" (Arellano and others 1982, 383). In December 1976, Meller argued that a rapid liberalization of trade could be extremely costly in terms of increased unemployment. He argued that as a result of the government reforms, including the deep liberalization of foreign trade, "[the] unemployment rate could easily increase to 23% of the labor force" (Arellano and others 1982, 387-89). The critics argued that Chile should abandon the experiment and move rapidly towards a program where the state would play a fundamental role in supporting key industries through higher tariffs, and other forms of subsidies. For instance, in 1983, Foxley argued that, "The State should articulate a 'vision' about the country's productive future...The idea is to pick and develop 'winners'...[To this effect] the State would use every instrument available..., including special credit lines, subsidies, import tariffs and tax exemptions."[29]

Starting in 1985, the Chilean economy began to recover vigorously; by 1989, it had accumulated a very strong record of growth, which surprised most analysts, including the

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[29] See Foxley (1983, 42-44). He goes on to suggest that under democratic rule import tariffs should be increased to an average of 30%, with a maximum effective rate of protection of 60 percent. He argued, however, that these policies would "not result in a return to the import substitution model, as was known in Chile and Latin America during the 1950s and 1960s" (p. 54).

domestic critics. As the Presidential elections of 1989 approached, it had become clear that the criticism of a market-based development path had subsided. In fact, the three presidential candidates presented remarkably similar economic proposals that shared many important elements. What was particularly important was that (future president) Patricio Aylwin's program — drafted mostly by the CIEPLAN group — proposed to continue with the most important market-oriented policies. The program argued for "low import tariffs," and for ensuring that the economy had "positive real interest rates that maintain some relation with productivity."[30] By early 1990, it was clear that the incoming government was not going to fiddle with the main elements of the market reforms. If anything, the new authorities were ready to move even further in some areas, such as a further reduction of the import tariff.[31] Coming from those that had relentlessly criticized the reforms, this action represented an important victory for free-trade ideas.

The Aylwin government's decision to maintain the main aspects of the market reforms was clearly stated by Minister of Finance, Alejandro Foxley, who in a 1990 interview pointed out that, "Preserving the former government achievements means maintaining an open economy fully integrated into world markets, dynamic growth in exports, with a private sector fully committed to the task of [economic] development ..."[32] Although once in power the leaders of the new democratic government supported some of the most fundamental market reforms of the

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[30] See Edwards and Edwards (1991, 222-226) for an early discussion of the Aylwin program.

[31] Tariffs were reduced to 11 percent across the board on June of 1991.

[32] Newsweek (Latin American Edition), March 26, 1990.

1970s and 1980s, they still had some important disagreements with the former rulers regarding the role of social and redistributive policies. In that regard Foxley was equally clear in the 1990 interview: "Remedying the former government shortcomings means recapturing the balance between economic growth and the deteriorated conditions of the middle and, above all, the lower classes." What is particularly important, however, is that in seeking funding for new social programs the new Chilean government strongly and decisively rejected traditional formulas based on inflationary finance. On the contrary, the new administration made it clear from day one that the only way to increase social spending without generating unsustainable macroeconomic pressures was to find additional government revenues. Furthermore, the new government continued the policy of targeting social programs on the poor, and avoiding blanket subsidies that historically benefitted the middle and upper classes. In short, the populist policies of yesteryear had no role in the new Chilean government.

An important political decision made by the new government was to address two critical economic reforms during its first year: a tax package aimed at funding the new social programs, and a reform of the labor law that had been criticized by union leaders and political commentators. Government officials were careful to explain that these two pieces of legislation constituted the <u>only</u> important modifications to the economic model established by Pinochet. In this way, and especially by tackling these issues early, the government sought to minimize possible negative effects on private investment associated with policy uncertainty (Boeninger 1992).

IV. Compensation Mechanisms and the Political Economy of Trade Reform

1. Distributive Conflicts and Interest Groups

Analyses of the politics of trade liberalization usually focus on conflicts among interest groups aiming to raise their shares of the national income. A common framework is based on some variant of neoclassical trade theory, including specific-factors models, and considers a finite number of interest groups; some will be hurt by the reform and will oppose it, those that benefit will support it. Rodrik (1994, 68) considers three groups: (1) import substituting industrialists; (2) holders of import licenses; and (3) users of imports, including producers that rely on imported inputs. Depending on the underlying model of an economy, we could add any number of groups with special characteristics, including: (4) agricultural producers, who often argue that food self-sufficiency is a matter of national security; (5) organized labor, especially those employed in import-competing industries; and (6) labor in the informal sector, which tends to be dispersed and disorganized. In this setup, the political support for the reform effort will be proportional to the difference between redistributed income and net efficiency gains; what Rodrik (1994, 67) calls the "political cost-benefit ratio."[33]

[33] The basic approach is based on the standard Stolper-Samuelson framework linking sectoral (factor) income shares to relative prices. It assumes that the interests of workers and capitalists are independent of the sector where they operate initially, and it ignores important macroeconomic considerations, including the potential role of the exchange rate. Extensions of the basic Stolper-Samuelson framework allow for additional actors, as well as complex relationships among them. A powerful extension, that has become popular among political scientists working on the political economy of trade, assumes that some of the factors (e.g. capital) are sector-specific. In this case, capitalist interests differ depending on which goods they produce. In this framework, owners of capital across sectors may have conflicting interests.

Since reforms are seldom restricted to one area of economic policy, a broader set of policies and interest groups should be considered.[34] Exporters are usually among the early supporters of reform-oriented governments; they benefit directly from the reduction of import tariffs affecting their inputs of production, and indirectly from the exchange rate depreciation that often takes place during the early stages of an liberalization program. Producers of import-competing goods usually oppose trade reforms, but are often at least partially compensated by the real depreciation of the currency. If the reform process is seen as a package, some import-competing sectors may support trade liberalization if they expect to benefit from labor market reforms, privatizations, or financial liberalization, for example. Unions representing the employees of state-owned enterprises are almost always among the opponents of economic reforms, but reformers often try to win them over by offering them some participation in the newly privatized firms. Moreover, political compensation schemes can also be devised to tame opposition to reforms, such as offering political appointments to influential representatives of a particular interest group. Table 5 provides a description of commonly used compensation schemes.

A relevant question for the Chilean case concerns the relationship between an authoritarian political regime and constraints faced by reformers. The fact that an authoritarian government does not face electoral challenges does not mean that reformers have a free hand inside a dictatorship; within a dictatorial regime there will be factions that represent interest groups. Reformers also have to convince military strongmen that their policies are appropriate,

[34] This does not mean that the basic principles of international trade theory cease to be relevant. In fact, the extended general equilibrium framework sketched here continues to be extremely powerful.

and the market-oriented perspective often clashes with the strongly nationalistic, state-centered views of the military.[35] Dictators also demand results -- although it may give reformers more time to obtain them -- and seek to maintain some degree of legitimacy, while political repression tends to be targeted to specific groups.[36] Limited freedom of expression under authoritarian regimes may also limit the scope of the market of ideas. As we argued in the previous section, while some limitations were imposed on the exposition of anti-reform ideas, especially in the immediate aftermath of the breakdown of democracy in Chile, criticisms were, indeed, published by the media during the period of reform.

From a political perspective, it is important to consider the Chilean reforms as a package. Of course, this does not mean that all reforms were designed to be undertaken simultaneously, nor that all were considered equally important by their supporters. What it does mean is that interest groups had to take a position with respect to the complete package, rather than with respect to some of its components. Table 6 provides a taxonomy of interest groups in Chile, and the expected effects of the reforms on these groups. Our contention is that the political economy of Chile's trade liberalization reflected the use of a variety of compensation schemes, some of which were embodied in the components of the reform package itself. Table 7 shows the various compensation mechanisms that were used by the Chilean authorities through the five stages of

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[35] For instance, a Chilean sociologist, Garretón (1986, 147), wrote that in the case of Chile, "we are... dealing with a program to lay the groundwork for a new social order... we must direct our attention to the capacity of diverse sectors in the dominant power bloc to achieve hegemony within it. The attempt to restructure society... can take several directions depending on the capacity of particular sectors to generalize these interests or to impose their own ideology within the victorious coalition." In fact, the general issue of "state autonomy" from economic and social interests has had a long trajectory in the social sciences. See, for example, the first, review chapter in Hamilton (1982). On some aspects of the political economy of Chile's reforms see, for example, Fontaine (1993).

[36] On the role of "legitimacy" see Linz (1978, 16-19).

the liberalization process; and the five stages of the process can be discerned by the types of mechanisms that were used in each phase. The rest of this section analyzes the affected interest groups, and the compensation schemes that were implemented during Chile's experiment with unilateral liberalization.

2. *A Taxonomy of Chilean Interest Groups*[37]

In order to organize the political analysis of Chile's reforms, we have divided the actors into six groups -- see Table 6. The first column lists the policy measures that were part of the reforms, while the following six columns show how each type of interest group was *expected* to be affected by each policy measure. The first group is composed of owners of capital or land in import-competing industries, which include manufacturers and producers of traditional agricultural products, such as wheat, sugar, and oilseeds. The second group is composed of export-oriented producers, including mining-related enterprises and nontraditional exporters. The third group is the nontradable industries, such as the construction and transport sectors. The fourth group is composed of the so-called *grupos*, or financial conglomerates, which controlled a large share of the banking sector and significant portions of export industries. The fifth and sixth groups are the formal, unionized workers and workers employed in the informal sector.

Of the import-competing groups, manufacturers have been organized under the umbrella of the *Sociedad de Fomento Fabril* (SFF) since 1883. Historically, the SFF had been at the center of the push to raise tariffs on imports of manufactures since 1897, when Law 980 was

[37] Campero (1984 and 1991) provides detailed analyses of the role of business associations in shaping the policies of the dictatorship.

passed, raising import tariffs on textiles and other manufactures (Douglas et al. 1980, 150). In the early 1970s the SFF represented producers of chemical products, steel, textiles, and other manufacturers that had benefitted from protectionist policies. While most of its members come from large and medium firms, it has also represented a number of small manufacturers. The traditional agriculturalists have been represented by the *Sociedad Nacional de Agricultura* (SNA) since 1838. However, this organization has a mixed membership that also includes the large agricultural producers of non-traditional agricultural products, such as fruits. In addition, both the SNA and the SFF belonged to a more general umbrella association of large and medium enterprises called the *Confederación de la Producción y el Comercio* (COPROCO). Finally, the *Confederación de Productores Agrícolas* (CPA) was founded in 1973, by the fusion of two associations of small and medium agricultural producers, which included producers of wheat and other traditional agricultural products.

In any case, the import competing sectors were expected to lose from the reduction of tariffs affecting their products, but were expected to gain from the currency devaluation which would raise the prices of their tradable goods, and from the labor market reforms which were expected to reduce their costs of production. In addition, owners of capital in these sectors could also benefit from the privatization of real-sector firms, and from the capital account liberalization that would reduce the costs of foreign finance. In contrast, the deregulation of domestic interest rates was expected to hurt those import-competing sectors that had benefitted from the subsidized credit that was available to them during the period of import substitution.

The producers of mining goods were represented by the *Sociedad Nacional de Minería*, while the exporters of nontraditional goods did not have a specific association at the outset of the reforms, but were progressively included in the umbrella of the COPROCO and the general business association *Cámara Central de Comercio*, which had been founded in 1858, and traditionally represented large export firms, including some of the most important wineries. As shown in table 6, these export industries were expected to gain from trade liberalization, export promotion policies, exchange rate depreciation, and even from the interest rate deregulation since it was expected that borrowing costs (interest rates) would fall for exporters who had not benefitted from the credit controls of the protectionist period.

The nontradable sectors were represented by business organizations such as the *Cámara Chilena de la Construcción,* which was founded in 1951, and several organizations affiliated with the *Consejo de la Producción, el Transporte y el Comercio*, most of which were founded between 1918 and 1973. In fact, many of its members had been key players in raising discontent with the *Unidad Popular* government during 1970-1973, for they had participated in several transport stoppages which tended to temporarily paralyze the domestic economy during this period.[38] The construction and transport sectors were expected to benefit from trade liberalization due to the lower prices of imported inputs of production, from labor market reforms, from the privatization of public firms, from the liberalization of the capital account, and perhaps, from the liberalization of interest rates. However, the currency devaluation was expected to reduce the relative price of nontradable goods.

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[38] See Campero (1984 and 1991).

The formation of large conglomerates -- the so-called *grupos*-- was a by-product of the financial reforms that were initiated in 1974, and especially of the privatization of the banks in 1975. By the early 1980s, these conglomerates owned a large share of Chile's financial system, and their lending activities were often concentrated in lending to related firms. Table 8 shows estimates of the extent of connected lending by several financial institutions and their share of the financial system's assets. The *grupos* also benefitted from the liberalization of the capital account, which raised the volume of funds intermediated by their banks, and from the pension reform that increased the size of the private financial market. Since the grupos owned export-oriented firms, they also benefitted from the policies that strengthened the export sectors.[39]

In the eve of the military takeover in 1973, the Chilean labor movement was represented through legal and "alegal" labor unions. The legal unions were recognized by the Labor Ministry, and encompassed industrial and agricultural unions. The former participated mostly in decentralized (firm-level) collective bargaining, while the latter were represented at the industry level. Moreover, the *Central Unica de Trabajadores* (CUT) was the national labor federation that had tight links to left-wing political parties. Nonetheless, the CUT played only a leadership role in the process of collective bargaining, and was seldom directly involved in collective bargaining (Barrera and Valenzuela 1986, 233). The "alegal" unions were not officially recognized by the State, but their existence was tolerated by most democratically elected governments. These unions, which often called themselves "councils" or "associations" represented most public employees, including those working in public enterprises. The legal

[39] On the effect of connected lending by the *grupos* see Arellano (1985) and Galvez and Tybout (1985).

union membership was expected to lose from labor market reforms that reduced the political influence of the CUT, while the alegal unions were clear losers of the privatization program. In contrast, labor employed in the informal economy were expected to gain from cheaper imports resulting from trade liberalization, but would lose from the pension reform that eliminated their public pensions.[40]

The labor market policies implemented during the period of trade liberalization will be discussed below. At this point, it should be acknowledged that the weakening of the labor movement during the military regime was dramatic. For example, union membership declined drastically from about 65 percent of total wage earners in 1973 to less than 20 percent on average for the 1980s (Cortázar 1997, 240). In spite of the military regime's policy of political repression targeting left-wing labor leaders, beginning in 1974, Pinochet invited center-right labor leaders to "informational" meetings, that were highly publicized, thus showing the General's concern about not appearing to be a labor antagonist. In July 1974, Pinochet appointed air force General Nicanor Diaz to the Labor Ministry; his primary mission was to create an institutional framework for labor participation in setting wage policies-- namely, "tripartite committees" encompassing government, management and labor leaders. (Coincidentally, the International Labor Organization began an inquiry into the violation of union rights precisely on July 1974.) This institutional arrangement failed to respond to labor's rank-and-file, who were experiencing a rapid deterioration of the purchasing power of their wages. Between December 1975 and 1978, labor discontent with the Chicago boys' program was articulated through the declarations of the

[40] However, the privatized, fully-capitalized system that replaced the publicly managed pay-as-you-go system does offer a minimum pension.

so-called Group of 10 labor leaders, plus several new labor organizations were formed during 1977-79, which were not shy in expressing their opinions -- see Barrera and Valenzuela (1986). Later, during the crisis of 1983-84, labor unions took to the streets in mass protests, and later played an important role in supporting the coalition that triumphed in the 1988 plebiscite. After the transition to democratic rule in 1990, the incoming administration negotiated with right-wing opposition in the Senate to enact legislation that enhanced the right to unionize for public and temporary agricultural workers, and abolished restrictions forbidding unions from different firms to participate in firm-level collective bargaining (Cortázar 1997, 250).

In sum, the set of affected interest groups and their representative organizations is quite extensive, reflecting a long history of collective action by the various groups. In the following section we take a closer look at the compensations mechanisms that were used to reduce the opposition and raise support for the package of reforms, which included trade liberalization.

3. Compensation Mechanisms during the First Stage of Reforms

As discussed earlier, the first stage of the liberalization process led to the drastic reduction of import tariffs and the elimination of non-tariff barriers (recall Tables 2 and 3). Several mechanisms to compensate (potential) opponents of the trade liberalization reform were used during this phase. In terms of direct compensation mechanisms, the authorities offered several export promotion policies: a rebate of the value-added tax introduced in 1975; a rebate on import duties paid on inputs to be reexported which was limited to direct importers of inputs; and a subsidy was offered to fishing and tree planting for lumber exports (de la Cuadra and Hachette

1991, 226).[41] As pointed out above, throughout the reform the authorities were concerned with unemployment. For this reason, in 1975, an emergency program -- the Minimum Employment Program (MEP) -- was launched, aiming to provide a subsistence wage to the unemployed in exchange for limited work. Table 9 shows the evolution of unemployment, wages, and the number of participants in the MEP.

The depreciation of the real exchange rate was perhaps the most important (indirect) compensation mechanism used throughout this period. By maintaining a weak (real) value of the peso it was expected that exporters -- as well as those that planned to move into the export sector -- would support the program, at the same time as import-substituting sectors would reduce their opposition. Figure 2 shows the evolution the dollar-based real exchange rate and the modal and maximum import tariff rates. The effects of the maxi-nominal devaluation of October 1973, began to be reversed in mid-1976, but the real exchange rate resumed its downward trend in mid-1977. This combination of trade liberalization, export subsidies, and exchange rate depreciation encouraged a frantic growth of non-traditional exports during 1974-1979. Figure 1 shows the shares of total export shipments of three product categories: mining, agriculture, and industry. The latter includes non-traditional exports such as salmon, trout, wines, lumber, fishmeal, and frozen fruits. It is remarkable that the share of those exports rose rapidly between 1974 and 1979, but this upward trend did not resume until the 1990s.

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[41] The fact that from an economic viewpoint the rebate on import duties eliminates the anti-export bias of the import tariff does not mean that this compensation scheme did not have political consequences.

The liberalization of the financial sector -- which included the privatization of banks and a decree passed on December 1974, prohibited the state-ownership of commercial banks, and freed interest rates (Ffrench-Davis and Sáez 1995, 73) -- was another important component of the reform package. It was expected that by deepening the financial sector more firms would have access to credit at relatively low rates. In a way, this (potential) availability of credit at reasonable rates was seen as a key component of the compensation package. Yet, as shown in Figure 3, real lending rates (for short-term 30-89 days credit issued by banks) were excessively high, ranging from 121 percent in 1975 to 35.1 percent in 1978. Hence the potential compensation to interest groups that had not benefitted from subsidized credit during the protectionist period, which could have emanated from these financial reforms were ineffective in terms of providing greater access to inexpensive credit for adjusting firms.[42]

Another form of indirect compensation that benefitted the private sector was the repression of labor unions that had aligned themselves with the Allende government, plus several other measures implemented to reduce the constraints on firing and hiring workers and promoted decentralized collective bargaining. On September 18, 1973, the authorities banned the presentation of union demands (*pliegos de peticiones*), and suspended the right of union leaders to spend working time dealing with union affairs. Later that year, other decrees were issued which had the following consequences: (a) made the firing of workers easier, including the firing of workers leading "illegal" strikes; (b) suspended existing agreements regarding salaries, benefits, and other remunerations; © suspended automatic adjustments of pensions to

[42] We have already mentioned that firms that benefitted from directed credit prior to the reforms lost such privileges.

compensate for inflation; and (d) suspended all organizational union activities (Barrera and Valenzuela 1986, 235-236).

A less well known fact is that the military dictatorship also offered exclusionary compensation mechanisms, even during this first stage of the liberalization process. For instance, subsidized credit to agricultural producers, and a price-stabilization fund for milk products, meat, wool, and even poultry, beans, onions, and potatoes were not eliminated until 1977 (de la Cuadra and Hachette 1991, 265). Moreover, in response to farm lobbies, a price band mechanism for wheat, sugarbeet, and oilseed prices was made operational in 1978, which was subsequently dismantled in mid-1979 under pressure "from the same farmer's organizations which foresaw that free trade prices would be above the ceiling price" (Quiroz and Valdés 1993, 3).[43]

Finally, it is noteworthy that also in response to the farm lobbies, the authorities offered political appointments to members of the SNA. In an interview published in July 1976, the president of the SNA, Alfonso Márquez de la Plata, said that, "We are absolutely in agreement with the current economic policies and we believe that there is no alternative. But we feel that certain measures should be adopted to make this program viable..." (cited in Campero 1984, 147, translated). As a result of the SNA's discontent, the cabinet was reshuffled, and a new Minister and vice-Minister of Agriculture were appointed. The vice-Minister position was given to a former officer (*Secretario*) of the SNA, Mr. Sergio Romero (Campero 1984, 147). Later in

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[43] On the discretionary application of the price bands, see also Chacra and Jorquera (1991), and footnote 8 above.

October, 1976, the SNA's Márquez de Plata inaugurated a conference by stating that, "Basic staples should be produced domestically, even at higher prices than in the international market, since they have a strategic character and they must be promoted..." (Campero 1984, 148, translated). The influence of the SNA would be felt during later stages of the liberalization process.

Another key political compensation mechanism was linked to the military's justification for displacing the Allende government. Namely, in spite of the initial uncertainty and an economic recession in 1974-75, entrepreneurs that had traditionally benefitted from protectionism were willing to support the economic program of the dictatorship for the sake of "saving the country" from communism. For instance, in December 1973, Mr. Orlando Sáenz, the President of the SFF, wrote that, "... we only know the general contours of the government's economic policy... A model of development cannot be alienated from the idiosyncracies of the population, nor can it go against the physical and historical continuities... Economic successes are merely vehicles for achieving political and social goals, but cannot become ends in themselves, this is what distinguishes a policy-maker [*Estadista*] from the technocrat: the former cannot be subjugated by the latter" (Campero 1984, 105, translated). Yet three months later, in March 1974, Sáenz said that, "the process is more revolutionary than reconstructive... The military junta proposes to act drastically to deal with the great problems of the country... The reconstruction will produce a new structure of the State, a new concept of development; different productive relations that lead us to an era of prosperity..." (Campero 1984, 106-107, translated).

Hence it is clear that the manufacturing sector was willing to accept the challenge of economic reform because the new government had set back the socialist program of the early 1970s.

4. The Failure of Indirect Compensation Schemes during the Second Stage

Table 8 also reveals that during the second stage there was an apparent shift in the use of compensation schemes, from a reliance on indirect measures to cross compensation schemes. In particular, as we have already discussed, the real exchange rate began to appreciate rapidly in 1979, partly as a consequence of the change in nominal exchange rate policies, and partially as a result of increasingly large capital inflows. Furthermore, real interest rates began to rise again in 1980 (see Figure 3). Both of these developments hurt exporters -- the early supporters of the reforms. At the same time, however, the implementation of broader aspects of the reforms, including the labor law and massive privatization, benefited the conglomerates, which became the more staunch supporters of the program.

The story of labor market reforms is particularly interesting. A new labor code was introduced in 1979, under the guidance of Labor Minister José Piñera, a Harvard-trained economist. The code established a new collective bargaining mechanism, whereby union affiliation within a firm became voluntary, and all negotiations were to be conducted at the firm level, thus eliminating industry-wide collective bargaining (Edwards and Edwards 1991, 104-105, for details). However, "in an apparent contradiction... the authorities made no change in the minimum wage regulation and introduced wage indexation, both policy decisions that are only explicable in terms of political considerations" (Riveros 1986, 24). Another observer noted that, "This law, written when the Chilean economy was at the height of its late-1970s boom, mandated essentially that every new labor contract must provide at a minimum a full cost-of-living adjustment from the date of the previous contract. For practical purposes, it made reduction in real wages illegal in any covered activity" (Harberger 1983, 6). With the nominal exchange rate pegged to the dollar at 39 pesos beginning in June 1979, the wage indexation mechanism was probably another important determinant of the real exchange rate appreciation that afflicted the Chilean economy during this phase of the liberalization process.

The process of privatization of state-owned enterprises that was initiated in 1974 proceeded throughout this period. One effect of the process was the creation and consolidation of the *grupos*. By 1979, the ten largest *grupos* controlled 135 of the 250 largest private corporations, and they controlled approximately 70 percent of all corporations traded in the stock market (Dahse 1979). During the second stage of the trade opening, the grupos benefitted from several other measures. For example, the partial elimination of capital controls led to a massive inflow of foreign capital intermediated by the *grupos* banks and other financial intermediaries, but worsening the real appreciation of the exchange rate.[44] Another example of a cross compensation scheme that benefitted the financial conglomerates is the social security reform of 1981, which led to the establishment of privately-managed pension funds, and the *grupos* invested heavily in these funds. Despite the fact that the grupos were "compensated" (by the partial liberalization of the capital account and the privatization of the pension system, both

[44] According to de la Cuadra and Hachette (1991, 227), "The government gradually opened the Chilean economy to foreign capital between 1974 and 1981. Medium-term capital movements were progressively deregulated (through reductions in reserve requirements), with overall global limits on borrowing eliminated in 1979; the only limitation on total bank indebtedness [was] the maximum allowed debt-to-capital ratio (20 to 1). Restrictions on monthly inflows were eliminated in April 1980. Short-term financial credits were not allowed until 1981."

entailing a form of cross compensation) as the real exchange rate continued to appreciate during this period, the profitability of industries in the tradables sector tended to deteriorate, and eventually many banks had to be bailed-out in January 13, 1983.

5. From Backtracking to Consolidation, 1983-1991

From a political economy perspective, one of the most apparent effects of the economic recession experienced in 1983-1985 was the shift to exclusionary compensation mechanisms (see table 8). It has already been mentioned that the uniform tariff was raised several times during this stage, reaching 35 percent in September 1984. However, the reversal was not limited to the uniform tariff. As a matter of fact, Table 10 lists the numerous surcharges that were applied to imports during this period. The great diversity of products, ranging from butter to refrigerators, indicates that these surcharges were the result of industry-specific lobbying efforts -- there is no apparent rationale for their imposition that would be justified by "optimal taxation" arguments. The system for setting the surcharges was launched in November 1981, at the zenith of the real exchange rate appreciation (see Figure 2). By December 1984, the authorities had received 123 requests for relief, alleging that imports were being subsidized by foreign governments. Yet the Chilean authorities did not follow contemporary procedures that existed under the General Agreement on Tariffs and Trade (GATT), that permitted country-specific compensatory duties, and opted for general surcharges that did not discriminate among countries.

De la Cuadra and Hachette (1991, 268) defend this position by arguing that, "in the history of GATT, there has not been a single case in which a small country has been able to apply a compensatory duty on imports from a large country, because it does not have the 'power' to do so. For example, when Chile intended to levy compensatory duties on a limited number of imports from Brazil, the pressures against doing so at diplomatic levels were such that the GATT mechanism did not work." Yet the timing of the implementation of this system of surcharges indicates that the authorities became "suddenly" preoccupied by foreign subsidies. A more likely explanation is that the authorities were once again responding to political pressures, even under an authoritarian regime. In addition, "between March 1983 and January 1990, imports were subject to a 120-day minimum financing requirement... In June 1988, the minimum financing requirement was lifted for imports below US$5,000... The exemption was later raised to US$20,000 in December 1988, and to US$50,000 in June 1989" (GATT 1991, 52).

Business associations were also compensated through political mechanisms. In February 1983, Manuel Martín, a leading industrialist, was appointed Minister of Economy. Subsequently, Modesto Collados, a construction entrepreneur, was named Minister of housing, and, later Minister of Economy. In 1985, Manuel Délano, who had led the Chamber of Commerce, was appointed to the same office. Furthermore, in 1984, a leader of the SNA, Jorge Prado, became Minister of Agriculture, and in 1986, a former President of the National Society of Mining, Samuel Lira, became Minister of Mining (see Campero 1991, 139-140).

In the midst of the economic crisis, the COPROCO published a document titled, "Economic Recovery: Analysis and Proposals," in July 1983, thus revealing that the entrepreneurs differed with the government on policy matters, including the low and uniform tariff level (Campero 1991, 139). On August 15, 1983, Finance Minister Carlos Cáceres responded to the COPROCO by stating that the government would only consider individual aspects of their proposals. According to Campero (1991, 140), "By mid-1984, the government had formulated a three-year plan... which incorporated many of the entrepreneurs' proposals... [including] agricultural and mining investments, a policy of job expansion, and an increase in import tariffs [from 20 to 35 percent] in order to protect national industry...." Indeed, by 1983, the government had resumed price interventions in agriculture, announcing a minimum import price for wheat that would be sustained through contingent variable import levies. In 1984, the minimum wheat price policy was incorporated into a price-band framework, and the program was extended to edible oil. Sugar was added to the system in 1985 (Quiroz and Valdés 1993). More generally, during 1983-85 the government was forced to negotiate a recovery program with the private sector, which led to the ambiguity of its economic policies. This flirtation with an all-out reversal of the liberalization process came to an end in 1985, when Mr. Hernán Buchi became Minister of Finance, and was able to reach a compromise between the orthodox views of the Chicago boys and the demands from the private sector to have a negotiated program in place (Campero 1991, 140).

As shown in Figure 2, the real exchange rate depreciated rapidly during the crisis years, thus providing additional compensation to tradable industries. As illustrated in table 8, once the economic recovery got underway after 1984, and well into phases four and five of the liberalization process, few compensation mechanisms were used to make the resumption of liberalization palatable. Nonetheless, the real exchange rate (both the bilateral and the multilateral rates) became more stable, as shown in Figure 4, thus acting as an effective indirect compensation mechanism at least by providing stability to the ratio between foreign and domestic prices.

As the economic recovery proceeded, the rate of unemployment also fell, while moderate inflation persisted in the double digits until the mid-1990s (see table 1). On the political side, the Constitution of 1980 had scheduled a plebescite referendum on Pinochet's regime for 1988. The democratically-elected government of Patricio Aylwin lowered the uniform tariff to 11 percent in 1991. It is noteworthy that this tariff reduction was implemented in conjunction with the establishment of exchange controls. More specifically, on the same date the government instituted a reserve requirement (for a minimum of 90 days) for short-term capital inflows. This policy mix highlights the Aylwin administration's concern about real exchange rate appreciation that Chile was experiencing as a result of a surge of capital inflows. From a political economy perspective, this combination of exchange controls and tariff reductions can be interpreted as an attempt to send a signal to the markets that the controls should not be interpreted as the beginning of a reversal of the market-oriented development model. In fact, three members of Aylwin's government who were in charge of trade policy matters have acknowledged that, "Even when the origin of the decision [to lower the tariff to 11 percent] had a macroeconomic motivation, the measure was consistent with the objective to consolidate the opening of the economy" (Saez, Salazar, and Vicuña 1995, 48, translated). Furthermore, a member of the Central Bank staff and a finance ministry official at the time have written that, "in order to sustain the real exchange rate, in June, 1991, the government lowered tariffs..., and imposed a series of measures on the capital market..." (Ffrench-Davis and Labán 1996, 58).[45] Hence it cannot be overemphasized that trade liberalization in periods of uncertainty can send a strong signal that incoming, especially left-of-center, governments will continue with a market-oriented development strategy. In the words of Edgardo Boeninger, the Minister Secretary General of the Presidency during the Aylwin administration, "The [Aylwin government], whose faith in the market was initially suspect for understandable historical reasons, has invested in entrepreneurial trust, both by language and by deed, conveying signals that have contributed to creating the perception that an enabling environment for private enterprise does in fact exist" (Boeninger 1992, 286).

V. Trade Liberalization and Unemployment: Preliminary Results

As we pointed out above, much of the criticism of the Chilean trade reform during the 1970s and 1980s was based on its effect on social conditions, including unemployment. Reform skeptics argued that by dismantling the protective structure -- and in particular, by doing it so fast -- firms were forced into bankruptcy, and unemployment soared. However, the fact that many reforms were being undertaken simultaneously made the analysis difficult. More specifically, it was difficult to disentangle the effects of trade liberalization from those of other policies, including the stabilization program aimed at taming inflation. Most analyses of labor market behavior during the Chilean reforms have been based on aggregate data (see Riveros 1986, for example). Therefore, it has been difficult to separate the effects of macroeconomic

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[45] The controls included a reserve requirement of 20 percent of external credits that had to be deposited in a non-interest-bearing account at the Central Bank for a minimum period of 90 days. In addition, a tax of 1.2 percent on domestic credit operations was extended to cover external loans (Ffrench-Davis, Agosín, and Uthoff 1995, 121).

developments -- including the stabilization program -- from those stemming from microeconomic reforms, including the liberalization of trade.

In a recent study, Edwards and Edwards (1996) used a large unemployment survey data set to explore, at the micro level, whether the Chilean trade reform affected unemployment during the 1970s and early 1980s. They ask the following basic questions: does the sector of origin affect the probability of being unemployed? More specifically, are workers originally employed in more "liberalized" sectors more likely to be unemployed? They used data from the University of Chile, June unemployment surveys for the Greater Santiago Area (GSA). Table 11 provides a summary of the data for 1976, 1979 and 1981. **Nemp** is a variable that takes the value of one if the individual is unemployed and zero if he/she is employed; **ex** is experience and is defined in years; **ye** is education and is also measured in years; **assets** refers to an estimate of the individual assets measured in current pesos, and is used as a proxy for the individual's reservation wage; **dhead** is a binary variable that captures whether the individual is a head of household; **lib** is the degree of liberalization of sector x relative to the previous period with available data; and **sex** classifies individuals by male/female.

Edwards and Edwards (1996) analyzed whether, after controlling for other factors, the degree of liberalization affects the probability of being unemployed. In principle, this question can be addressed by estimating probit equations. A summary of their results are presented in Table 12. As can be seen, most of the coefficients are significant at conventional levels. These results suggest that the probability of being unemployed declines with experience and schooling -- although the schooling coefficient is not significant in 1979, and only slightly significant in

1981. Interestingly enough, and perhaps a bit surprising, those with lower assets appear to have a larger probability of being unemployed. Heads of households and males also appear as having a significantly lower probability of being out of work. The degree of liberalization seems to affect the probability of being unemployed positively. This supports, then, the view that in the case of Chile, trade liberalization contributed to the surge of unemployment experienced in the 1970s. As pointed out previously, however, these results should be interpreted with caution. The reason for this is that, contrary to the other variables in the analysis, **lib** is not an invariable characteristic of the individual. In fact, it is possible that the "sector" variable means different things for different people in the sample. Further analysis undertaken by Edwards and Edwards (1996) indicates that liberalization not only affected positively the probability of being unemployed, but also unemployment duration. After controlling for other variables, individuals in those sectors affected more severely by the reforms experienced longer unemployment spells.

VI. Concluding Remarks, or Flirting with Regionalism

The advent of regionalism to the Western Hemisphere has become part of Chile's economic and political realities. It is now unclear whether Chile's love affair with unilateralism has run out of passion, and it is also uncertain whether Chile's recent flirtation with regionalism will lead to the end of its remarkable experience with unilateral liberalization. Two considerations support this reasoning.

First, it is possible that the authorities may have attempted to "strengthen" their positions for the "upcoming" negotiations to enter NAFTA by maintaining the current level of the tariff at

11 percent.[46] Parliament was considering another reduction in the uniform tariff in 1997, but this project may have been shelved in the aftermath of the Asian crisis, due to a deterioration of Chile's current account.[47] In any case, most of the policy debate at this time has focused on the role of tariff changes as determinants of the real exchange rate, which is a legacy of the late 1970s and mid-1980s, as well as on the fiscal consequences of the proposed tariff reduction. The lesson from past experience is that automatic adjustment mechanisms based on the downward adjustment of non-tradable prices do not work, and that tariffs are an inappropriate means for raising fiscal revenues. Regarding the former, a change in the tariff by itself cannot bring about a real depreciation -- it is not the proper policy lever to accomplish that. Since the peso has been appreciating moderately since 1995 (recall Figure 4), many interest groups in tradable industries have used this fact as a justification for demanding special treatment, including former allies of the military government such as the SNA.[48]

Second, some of Chile's regional partners are world-class producers of traditional agricultural products. The country has signed and implemented trade agreements with Argentina, Brazil, and Canada, and perhaps (but increasingly unlikely) with the United States in

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[46] For example, Saez et al. (1995, 46, translated) argued that when the Aylwin Administration came to power in 1990, they had "to consider, to promote exports as well as better market access, the implementation of complementary policies [to unilateralism] that would provide greater reciprocity were required... hence the strategy began to be shaped as various opportunities changed the scenarios, thus incorporating the negotiation of free trade agreements into the trade policy agenda."

[47] "Chile Backs Off from Planned Tariff Cut," The Journal of Commerce, March 3, 1998, p. 1A.

[48] Again, trade-policy makers of the Aylwin Administration wrote that, "during [the early 1990s] the authorities had to face sectorial pressures to raise the level of protection... In practice, it is possible to conclude that these pressures were not fruitful and the sectors were left to operate under a uniform protection environment" (Saez, Salazar, and Vicuña 1995, 49, translated).

the near future. The phasing-out of the agricultural price-band mechanisms in the context of the agreement with the Mercosur countries will have obvious losers, namely the membership of the SNA. In fact, the ratification of the agreement ran into trouble in 1997, mainly as a consequence of political pressure exerted by agricultural interests on conservative elements of Parliament. The SNA again claims that its members represent a special sector, worthy of special favors. The last two democratic governments have already used an exclusionary compensation mechanism in the form of the long phase-out period. It is reasonable to expect some "senescent industry" protection for traditional agriculture in the coming years.[49]

[49] On senescent industry protection see Hillman (1982) and Cassing and Hillman (1986).

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Table 1. Chile: Macroeconomic Indicators, 1974-1996

(period averages, percentages)

	74-75	76-79	80-81	82-83	84-85	86-89	90-93	94-96
1. Economic Activity								
GDP Growth	-6.2	7.4	6.7	-7.6	4.4	7.3	6.9	6.6
Investment/GDP*	15.4	15.6	19.5	12.9	14.8	23.5	26.5	27.2
Unemployment Rate *	13.5	13.8	10.9	18.6	12.2	5.3	5.9	5.7
2. Domestic Prices								
Inflation	358	69	20	22	25	18	18.0	8.7
Real Wage Variation	-4.1	14.3	8.8	-5.5	-2.1	2.6	3.9	5.1
Real Exchange Rate Variation	83.0	1.4	-13.2	15.7	13.3	4.5	-2.8	-3.7
Real Interest Rate	15.9	43.9	24.8	25.1	11.1	8.9	11.1	9.9
3. External Sector								
Terms of Trade Variation	-33.1	2.6	-3.5	-3.6	-5.4	7.3**	-3.6	1.6
Export Volume Variation	22.2	15.3	2.0	2.7	6.8	11.1	9.5	9.3
Trade Balance/GDP*	-2.0	-2.8	-10.3	2.7	2.8	4.5	-2.3	8.6
Current Account/GDP*	-5.2	-5.4	-14.5	-5.4	-8.3	-1.8	-4.8	0.1
External Debt/ Exports*	3.1	1.6	3.1	4.0	4.6	1.7	1.6	1.1
4. Macroeconomic Policies								
Fiscal Surplus/GDP*	2.1	5.2	3.3	-1.2	-0.2	5.0	0.8	1.3
Growth of M1	260	112	31	6	23	37	28	19.7
Nominal Exchange Rate	390	47	--	49	45	13	5	-0.8

* Refers to the value corresponding to the last year in the period

** 1987-89

Source: Banco Central de Chile, Instituto Nacional de Estadística (INE), Edwards (1984), Fontaine (1996, table 1)

Key:

GDP Growth: refers to the variation of annual average GDP, measured at constant prices of 1977 for the period 1976-85, and at 1986 constant prices for the period 1986-96.

Table1, Key (continued):

Investment/GDP: refers to the fixed investment coefficient of GDP, where both numerator and denominator are measured at constant prices.

Terms of Trade: refers to the average annual variation of the index measuring exports of goods and services in relation to the unitary value of imports of goods and services.

Unemployment Rate: 74-81, see table 7; otherwise, refers to the value from Oct. to Dec. of each year, based on the National Survey conducted by INE.

Inflation: refers to the variation of the official CPI calculated from December to December of every year.

Real Wage: variation in real wages calculated by INE, from Dec. to Dec. of each year (overlapping in 1982 and 1983 to cover methodological redefinitions.

Real Exchange Rate: multilateral index in relation to Chile's commercial trading partners, as calculated by the Banco Central (for 1974-78, IMF series used for the other periods). A positive variation reflects a depreciation.

Real Interest Rate: refers to the average short term (30-89 days) rate of credit that banks offer, deflated by a variation of the CPI.

Export Volume: defined at constant prices for non financial goods and services.

Trade Balance/GDP: measures non financial goods and services, net imports of non financial goods and services as a fraction of GDP, all expressed at current prices of each year.

Current Account/GDP: Balance of the current account of the balance of payments, as a fraction of GDP at current prices.

External Debt/ Exports: total external debt in relation to exports of goods and services.

Fiscal Surplus/GDP: fiscal balance, excluding interest payments as a percentage of GDP.

Growth of M1: variation from Dec. to Dec. in nominal terms of M_1A (plus liquid deposits).

Nominal Exchange Rate: variation from Dec. to Dec. of nominal exchange of the peso in relation to the dollar.

Table 2. The Elimination of Non-Tariff Barriers (NTBs)

Instruments	The Situation in 1973: Number of Product Categories Affected (approx. 63% of total)	Dates When Relaxed and Eliminated
A. Import Prohibitions	187	August 1976: Down to 6 products April 1978: Down to 5 products August 1981: All eliminated
B. Prior Deposits*	2,872	January 1974: Waivers granted August 1976: Eliminated
C. Import Licenses**	2,278	January 1974: Eliminated

* A 90-day-non-interest-bearing prior deposit to the Central Bank, equivalent to 10,000 percent of the c.i.f. value of imports.

** Official approval required for importing.

Source: de la Cuadra and Hachette (1991, 218-219) and Mendez (1979, 81).

Table 3. Itinerary of Import Tariff Reductions, 1973-1991
(percentage of c.i.f. value of imports, nominal tariffs)

Date (m/d/yr)	Maximum Tariff	% of Items Subject to Maximum Tariff	Tariff Mode	% of Items	Avg. Tariff
12/31/73	220	8.0	90	12.4	94.0
03/01/74	200	8.2	80	12.3	90.0
03/27/74	160	17.1	70	13.0	80.0
06/05/74	140	14.4	60	13.0	67.0
01/16/75	120	8.2	55	13.0	52.0
08/13/75	90	1.6	40	20.3	44.0
02/09/76	80	0.5	35	24.0	38.0
06/07/76	65	0.5	30	21.2	33.0
12/23/76	65	0.5	20	26.2	27.0
01/08/77	55	0.5	20	24.7	24.0
05/02/77	45	0.6	20	25.8	22.4
08/29/77	35	1.6	20	26.3	19.8
12/03/77	25	22.9	15	37.0	15.7
06/78[a]	20	21.6	10	51.6	13.9
06/79[a]	10	99.5	10	99.5	10.1
03/23/83	20	99.5	20	99.5	20.0
22/09/84	35	99.5	35	99.5	35.0
03/01/85	30	99.5	30	99.5	30.0
06/29/85	20	99.5	20	99.5	22.0
01/05/88	15	99.5	15	99.5	15.0
06/91	11	99.5	11	99.5	11.0

[a] During 1978 and the first half of 1979 the tariff schedule was linearly reduced.

Source: Ffrench-Davis (1980 [1986]) and Saez, et al. (1995).

Table 4. Effective Rates of Protection in Manufacturing Sectors
(percentages)

Sector	1974	1976	1978	1979
Food stuff	161	48	16	12
Beverages	203	47	19	13
Tobacco	114	29	11	11
Textiles	239	74	28	14
Footwear	264	71	27	14
Timber products	157	45	16	15
Furniture	95	28	11	11
Paper products	184	62	22	17
Publishing	140	40	20	12
Leather products	181	46	21	13
Rubber products	49	54	26	15
Chemicals	80	45	16	13
Petroleum and coal	265	17	12	13
Nonmetallic minerals	128	55	20	14
Basic metals	127	64	25	17
Metallic industries	147	77	27	15
Nonelectrical machinery	96	58	19	13
Electrical machinery	96	58	19	13
Average	151.4	51.0	19.7	13.6
Standard deviation	60.4	15.7	5.3	1.7

Source: Aedo and Lagos (1984)

Table 5. The Political Economy of Reform and Compensation Mechanisms

MECHANISMS	MAIN FEATURES AND SOME EXAMPLES
A. Direct Compensation	*Groups directly affected by the reform policy are compensated through the transfer of cash or financial securities.* In this way the authorities expect to see a reduction in the extent of opposition from that group to that particular reform. Examples of this type of compensation mechanisms include the distribution of shares of privatized firms to workers in that particular firm, and adjustment assistance programs to workers who lost their jobs as a consequence of trade liberalization. The increase in take-home pay following a social security reform is another good example of this type of direct compensation scheme.
B. Indirect Compensation	This mechanism implies *compensating groups affected by a particular reform through the adjustment of a different policy that indirectly raises their revenues or reduces their costs of production.* In some cases this type of indirect compensation is "automatic", and is the result of normal economic forces at work. In others it is the result of specific policy measures. One of the most important indirect compensation mechanisms is the real exchange rate (RER). By devaluing the real exchange rate, import substituting sectors are partially compensated, while exporters experience an additional boon. Providing tax exemptions to sectors affected by deregulation constitutes another common form of indirect compensation.
C. Cross Compensation	*This mechanism entails transferring resources -- either directly or indirectly -- to groups not directly affected by the reform*, in order to obtain their political support. Transferring shares of privatized firms to the population at large -- as in Bolivia's capitalization program -- is a good illustration of this mechanism at work.
D. Exclusionary Compensation (i.e., Exemptions)	*Entails excluding certain powerful groups from the effects of a reform, or implementing policies that in effect exempt some sectors from the reform in order to diffuse their political opposition.* By allowing these groups to maintain certain privileges it is expected that they will not become active antagonists. The special treatment given to the Chilean armed forces regarding that country's social security reform is a classic example of this type of compensation mechanism.
E. Political Compensation	*This mechanism encompasses political "carrots and sticks."* For example, the appointment of influential representatives of certain groups to high-level government jobs, which often sends a (symbolic) signal to interest groups that their concerns will be addressed. On the negative side, there are politically exclusionary practices, such as political repression and persecution, which may benefit some groups at the expense of the victims.

Table 6. Expected Winners (W) and Losers (L) of Economic Reforms in Chile

Measure	Import-Competing	Exporters	Non-tradables	Grupos (conglomerates)	Formal-Organized Labor	Informal Labor
Trade Lib.	L	W	W	W	L	W
Export Promotion		W		W		
Depreciation	W	W	L	W		
Bank Privatization				W		
Financial Dereg.	L	W	W	W		
Pension Reform				W	W	L
Capital Account Lib.	W	W	W	W		
Privatization of Real-Sector Firms	W	W	W	W	L	
Labor Reforms	W	W	W	W	L	W

Source: See text.

Table 7. Compensation Mechanisms and the Stages of Liberalization in Chile, 1974-1990s

	I	II	III	IV	V
MECHANISM	1974-79	1979-82	1983-85	1985-90	1991-?
A. DIRECT					
1. Employment Prog.	X	X	X		
2. Duty Drawbacks	X	X	X	X	X
B. INDIRECT					
1. RER	X		X	X	X
2. Financial Reforms	?				
3. Labor Reforms	X	?			
C. CROSS					
1. Privatization	X	X			
2. Pension Reform		X			
3. Capital Account Lib.		X			
D. EXCLUSIONARY					
1. Surcharges			X		
2. Price Interventions			X		
3. Reversals			X		
E. POLITICAL					
1. Appointments	X		X		
2. Repression	X	X	X	X	
3. Democracy					X

Source: See text.

Table 8. Economic Conglomerates and the Chilean Financial System in the Early 1980s

Group and bank	As % of the system in Dec. 1982			Connected lending as % of institution's total lending	
	Capital and Reserves	Loans	External Credits	June '82	April '83
BHC					
BHC[a]	2.1	3.3	3.6	28.2	27.4[c]
Chile[b]	12.5	20.0	28.1	16.1	17.8
Morgan-Finansa	1.0	1.6	1.4	7.2	7.1
Cruzat-Larrain					
Santiago[b]	11.8	11.8	12.1	44.1	47.8
BHIF	1.8	3.3	1.9	17.1	19.8
Colocadora[b]	1.4	2.0	1.5	23.4	24.2
Edwards					
de A. Edwards	2.0	3.1	3.3	15.9	14.4
Errázuriz					
Nacional	1.9	1.9	1.5	29.1	27.5
Luksic					
Sudamericano	3.1	4.6	6.4	13.0	18.1
O'Higgins	2.7	2.8	3.3	8.0	12.1
Matte					
BICE	1.0	1.2	1.4	4.0	4.2
Yarur					
Crédito e Inversiones	3.8	5.1	4.9	8.6	12.1
Other Banks					
Concepción[b]	3.5	4.1	4.4	17.0	12.0
Internacional	1.2	1.1	0.6	20.1	20.5
Trabajo	2.3	2.9	2.9	1.6	3.3
Osorno	2.3	2.1	1.0	3.4	9.4
BUF[a]	1.3	2.1	1.9	5.1	7.6[c]

[a] Closed for bankruptcy in January 1983.
[b] "Intervened" in January 1983.
[c] December 1982.

Source: Foxley (1986, table I.21) based on data from the *Superintendencia de Bancos e Instituciones Financieras*.

Table 9. Unemployment and Wages in Chile, 1970-83

	(1)	(2)	(3)	(4)	(5)	(6)
Year	Labor Force (1000s)	U (1000s)	Open U Rate (%)	MEP (1000s)	MEP (% of Labor Force)	Real Wages (1970=100)
1970	2,923.2	167.1	5.7			100.0
1971	2,968.8	112.8	3.8			125.4
1972	3,000.8	93.0	3.1			125.4
1973	3,037.0	145.8	4.8			86.0
1974	3,066.8	282.1	9.2			90.2
1975	3,152.9	425.6	13.5	41.7	1.3	88.7
1976	3,216.4	511.4	15.9	168.8	5.2	86.3
1977	3,259.7	462.9	14.2	187.1	5.7	96.6
1978	3,370.1	478.6	14.2	148.0	4.4	97.5
1979	3,480.7	480.3	13.8	128.4	3.7	98.7
1980	3,539.8	417.7	11.9	187.9	5.3	108.3
1981	3,669.3	400.0	10.9	171.2	4.7	115.7
1982	3,729.7	760.9	20.4	190.2	5.1	112.2
1983	3,797.5	706.3	18.6	391.6	10.3	n.a.

Notes and Sources: U means unemployment. The Minimum Employment Program (MEP) was a temporary palliative system created by the government in 1975 to alleviate the unemployment problem. The labor force and unemployment figures (columns 1, 2 and 3 refer to June of each year) were estimated by Castañeda (1983). Column 4 is based on Banco Central (1983, 212-13). Column 5 corresponds to the quotient of column 4 divided by column 1. Column 6 was constructed using National Accounts data. See A. Edwards (1984, 85) for further details.

Table 10. Surcharges Applied to Imports, 1982-1986

Product	Initial Surcharge (%)	Surcharge as of Sept. 1984 (%)	Surcharge as of Dec. 1986 (%)	Date of Enforcement
1. Preserved fish	16	15	--	12 Nov 82
2. Matches	12	15	5	12 Nov 82
3. Condensed milk	18	10	--	4 Nov 82
4. Leather footwear	18	15	--	12 Nov 82
5. Wool fabrics	10	15	9	12 Nov 82
6. Cement	21	15	--	12 Nov 82
7. Fabric for bags	16	15	6	12 Nov 82
8. Cotton yarn	15	15	--	12 Nov 82
9. Aluminum	20	15	--	12 Nov 82
10. Powdered milk	28	15	15	12 Nov 82
11. Butter	16	15	15	12 Nov 82
12. Cheese	12	15	15	12 Nov 82
13. Water meters	22	15	--	12 Nov 82
14. Acrylic yarn	15	15	--	12 Nov 82
15. Cotton fabrics	20	15	6	12 Nov 82
16. Continuous filament yarn	15	15	--	8 Jan 83
17. Clothing	15	15	5	8 Jan 83
18. Toys	4	15	--	15 Mar 83
19. Cookies	10	15	--	15 Mar 83
20. Propylene bags	23	15	--	15 Apr 83
21. Beverage bottles	6	15	--	28 Apr 83
22. Flat glass	7	15	10	28 Apr 83
23. Corduroy fabrics	15	15	8	20 Jul 83
24. Tires	15	15	8	28 Sep 83
25. Wheat flour	15	15	--	28 Sep 83
26. Towels	15	15	5	5 Nov 83
27. Candies	15	15	--	9 Dec 83
28. Rugs and carpets	15	15	5	9 Dec 83
29. Bed sheets	15	15	7	9 Dec 83
30. Steel cables	15	15	--	9 Dec 83
31. Refrigerators	15	15	--	9 Apr 84
32. Floor polishers	15	15	--	9 Apr 84
33. Blenders	15	15	--	9 Apr 84
34. Metal gabions	15	15	0	3 Aug 84
35. Single-phase electric meters	--	--	6	28 Jun 86
36. Textile appliances	--	--	5	28 Jun 86

Source: de la Cuadra and Hachette (1991, 269), based on data from the Central Bank of Chile.

Table 11. Data Set Characterisitics, 1976, 1979, and 1981

A. 1976

Variable	Observations	Mean	Std. Dev.	Min.	Max.
nemp	4738	0.141	0.348	0	1
ex	4738	19.788	13.204	0	83
ye	4738	8.454	4.308	0	19
asset	4738	39.408	137.760	0	1998
dhead	4738	0.541	0.498	0	1
lib76	4738	-0.10	0.196	-0.676	0.406
sex	4738	0.346	0.476	0	1

B. 1979

Variable	Observations	Mean	Std. Dev.	Min.	Max.
nemp	5373	0.125	0.331	0	1
ex	5373	18.870	13.302	0	71
ye	5369	9.197	4.125	0	19
asset	5373	258.735	895.369	0	12999
dhead	5373	0.496	0.500	0	1
lib79	5373	-0.015	0.034	-0.109	0.053
sex	5373	0.354	0.478	0	1

C. 1981

Variable	Observations	Mean	Std. Dev.	Min.	Max.
nemp	5369	0.081	0.273	0	1
ex	6778	21.196	14.418	0	85
ye	6755	8.947	4.046	0	19
asset	7335	44.973	249.501	0	9000
dhead	7336	0.447	0.497	0	1
lib81	7336	-0.004	0.015	-0.060	0.100
sex	7336	0.500	0.500	0	1

Source: See text.

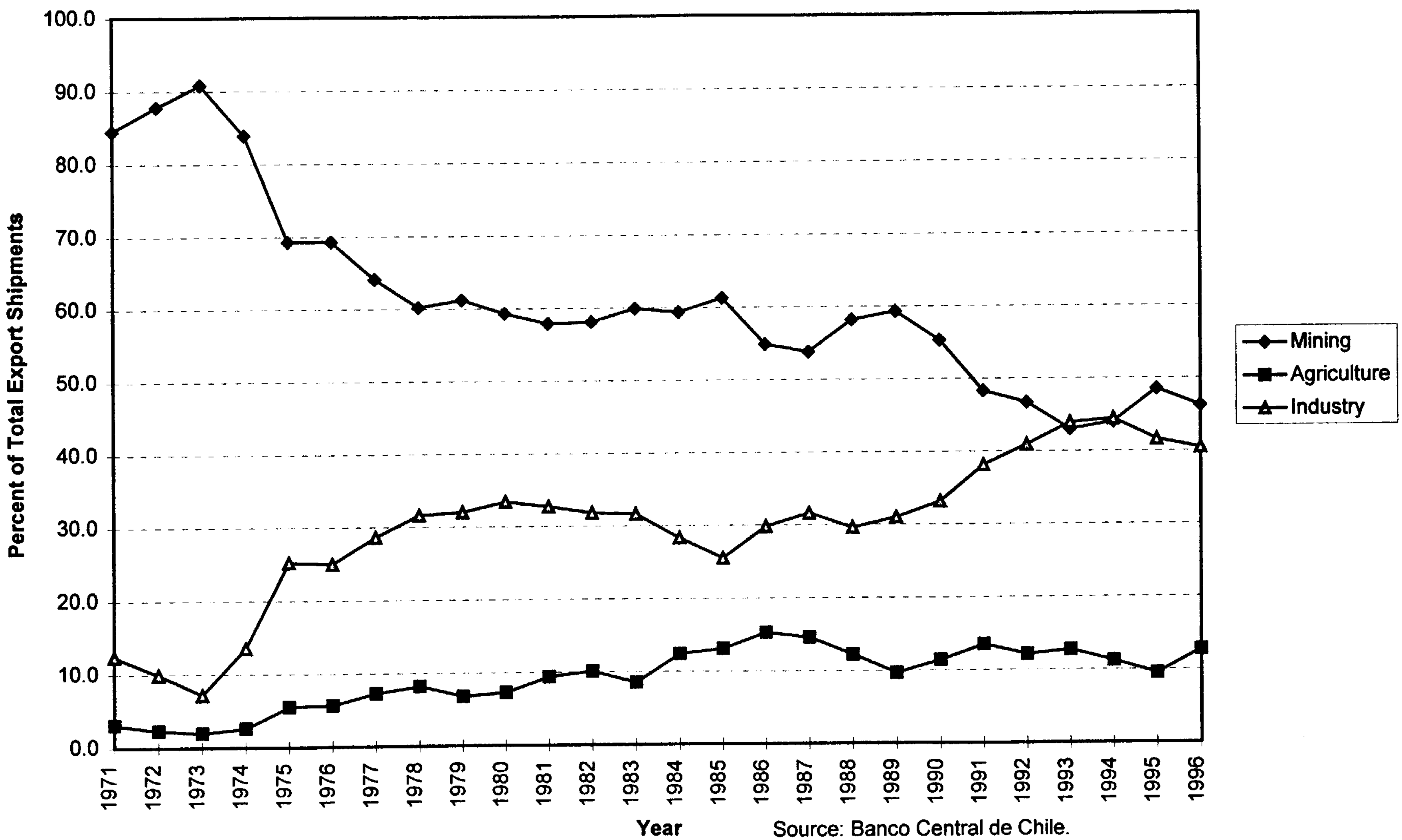
Table 12. Estimated Probability of Being Unemployed, 1976, 1979, and 1981

(Probit regression results, P-values in parenthesis)

Variable	1976	1979	1981
ex	-0.005*	-0.001	-0.003
	(0.019)	(0.586)	(0.210)
ye	-0.074*	-0.054*	-0.033*
	(0.000)	(0.000)	(0.000)
asset	-0.005*	-0.000*	-0.003*
	(0.000)	(0.000)	(0.000)
dhead	-0.359*	-0.255*	-0.099
	(0.000)	(0.000)	(0.176)
lib	-0.347*	-1.794*	-1.732
	(0.003)	(0.009)	(0.262)
sex	-0.391*	-0.404*	-0.254*
	(0.000)	(0.000)	(0.000)
constant	-0.049	-0.545*	-0.936*
	(0.541)	(0.000)	(0.000)
Observations	4,738	5,196	5,196

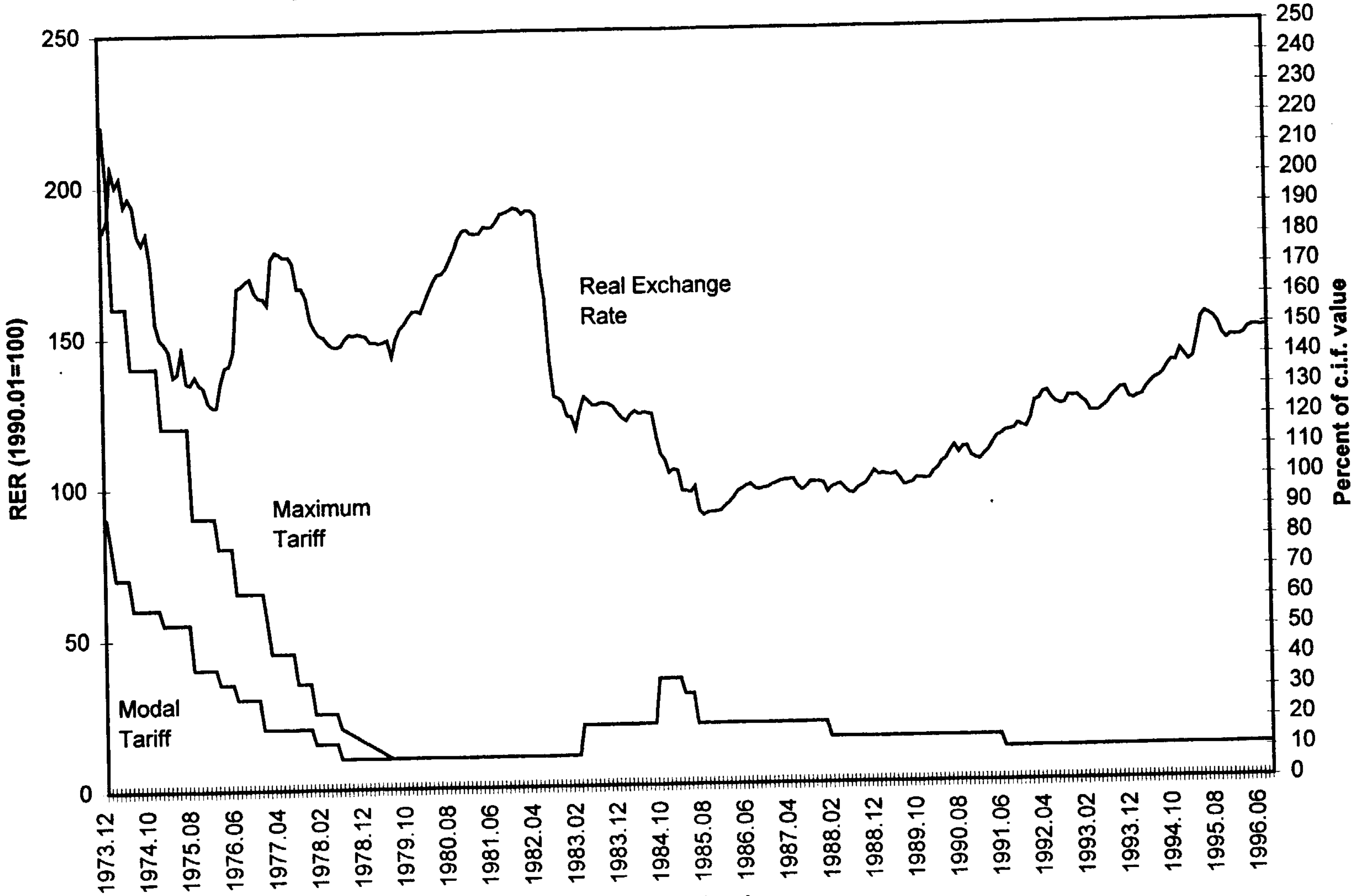
* Within 95% confidence interval

Figure 1. Chile's Export Structure, 1971-1996



Source: Banco Central de Chile.

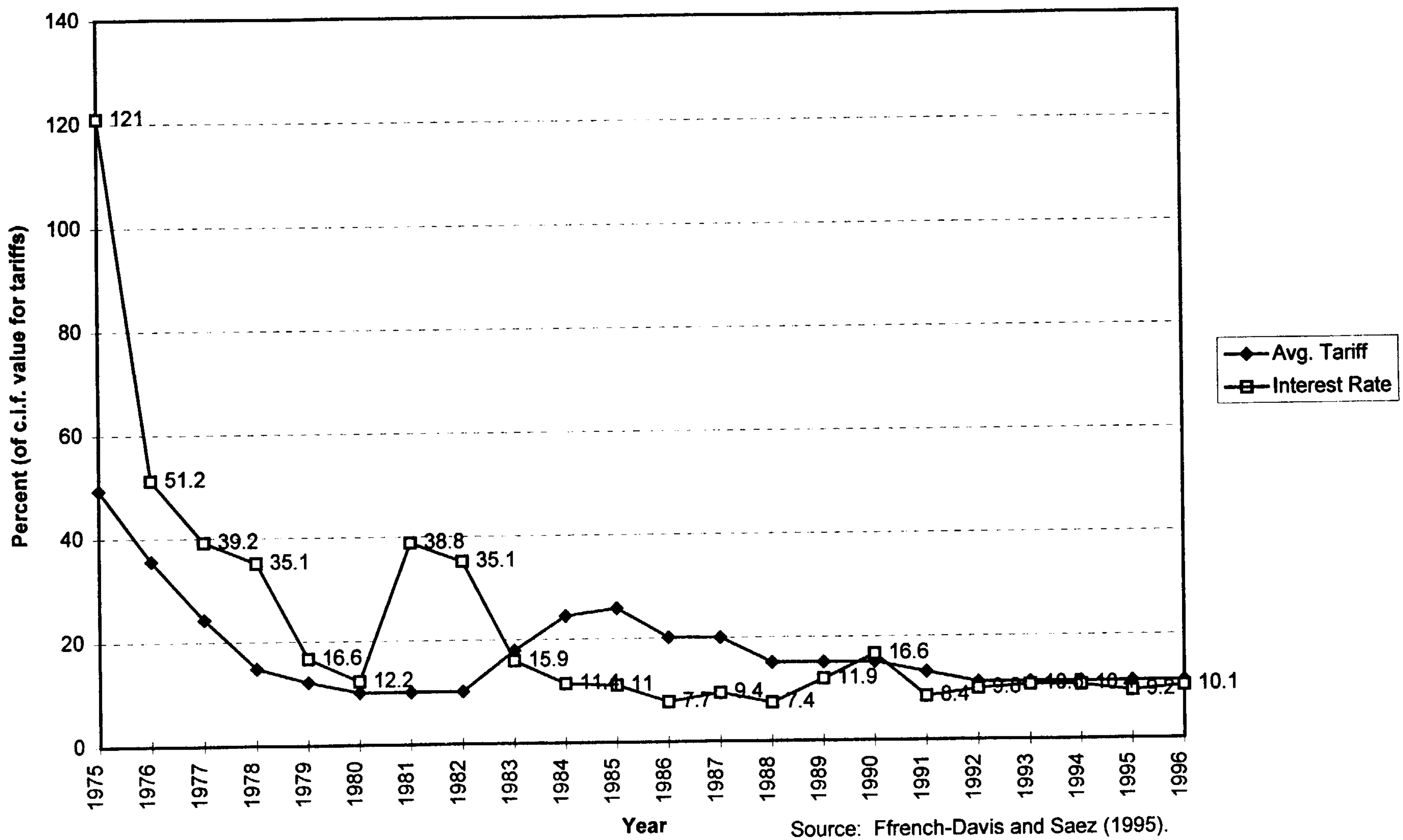
Figure 2. Tariff Reductions and the Real Exchange Rate, 1973-1996



Note: A rise in RER represents an appreciation.

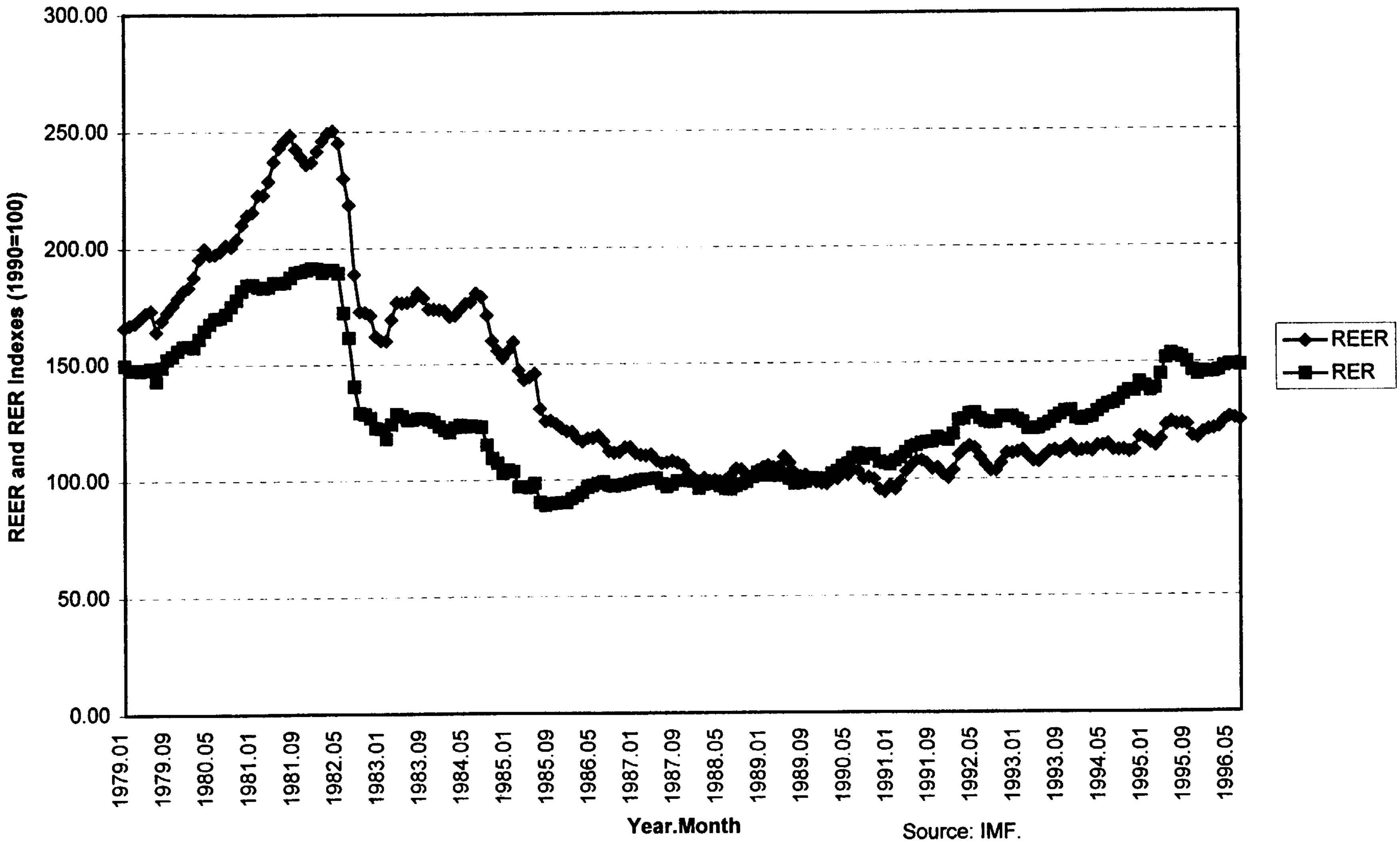
Source: USPPI , Chile CPI, and nom. rate from IMF.

Figure 3. Average Tariffs and Real Interest Rates, 1975-1996



Source: Ffrench-Davis and Saez (1995).

Figure 4. Chile: REER and RER, 1979-1996



Source: IMF.