

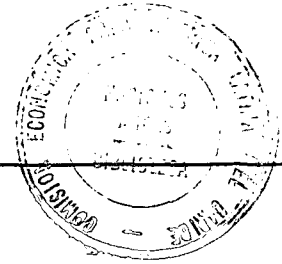
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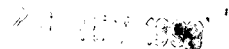
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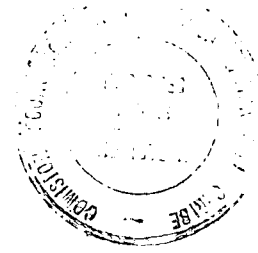
**STRUCTURAL ADJUSTMENT AND FOREIGN DIRECT INVESTMENT:
THE CASE OF CHILE ***

* This publication was prepared by Mr. Manuel Agosín, consultant of the ECLAC/Department of Economic and Social Development (DESD) on Transnational Corporations. This document has been reproduced without formal editing and the views expressed herein are those of the author and do not necessarily reflect the views of the Organization.

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Introduction

In the last two decades, the Chilean economy has undergone an intense structural adjustment process as the result of economic reforms whose main purpose was to re-orient resources from import substitution activities towards the export sector. The main policy orientation was the retreat of the State from productive activity and the surrender of economic decision-making to market forces. To a large extent, the objectives of the reforms was achieved: there was an accelerated expansion and a substantial diversification of exports, particularly in the 1980s, and manufacturing production for the domestic market shrunk significantly in relation to GDP. But social and economic costs were high: during 1974-89, the economy expanded at the meagre rate of 1 per cent in per capita terms and the investment ratio was considerably lower than during the more protectionist 1960s (it never surpassed 20 per cent). Moreover, the liberalization programme, together with crass mistakes in the management of exchange rate policy, led to the destruction of part of the capital stock in manufacturing, which could have been used as a basis for a more dynamic process of opening toward the international economy.

The Chilean economy today is quite different from what it was before the reforms. The weight of the export sector GDP has risen from about 15 per cent in 1970 to about 35 per cent today. While still dominated by products based on natural resources, exports have become quite diversified. The importance of copper has fallen from over 80 per cent to about 45 per cent. Significant revenues are now earned in the exports of fruits and vegetables, wood and wood products, and fish products. Transnational corporations (TNCs) have played an important role in the process of export diversification.

This study describes the economic reforms implemented in Chile as they relate to foreign trade, finance and investment. It also evaluates their efficiency in the structural transformation of the economy and in orienting TNCs toward the chosen goals.

The Economic Reforms

The economic reforms which were implemented starting in 1974 included a liberalization of the current and capital accounts of the balance of payments and the adoption of a very favourable régime for foreign direct investment (FDI).

Trade and Exchange Rate Policies 1/

The situation immediately preceding the reforms was characterized by countless quantitative controls over trade flows, a wide dispersion in tariff rates, and the use of multiple exchange rates. Chilean foreign trade was highly restricted, and interventions had lost their economic rationale. Therefore, a significant measure of trade liberalization was indispensable. The first measures taken consisted in the elimination of quantitative restrictions, the reduction in tariff peaks and the unification of the exchange rate. From 1974 to 1979, the authorities proceeded to lower tariffs and reduce their dispersion until a uniform tariff of 10 per cent was reached in 1979. Although the rate has been modified from time to time, the principle of a single tariff rate has been maintained since then.

From the very beginning of the reform, it was announced that tariff reductions would be accompanied by compensatory devaluations. However, with the passage of time, and faced with a stubborn inflation, exchange rate policy was increasingly assigned a monetary policy role. In 1979, the nominal exchange rate was fixed even though domestic inflation continued to exceed international inflation. Summing up, during 1974-82, foreign trade barriers were practically eliminated, but this was accompanied by a gradual appreciation of the real exchange rate from 1977 onwards (see figure 1).

The foreign exchange crisis which exploded in 1981 eventually led to a stiff devaluation of the peso, followed by the adoption of mini devaluations which exceed the differential between national and international inflation. Between 1981 and 1988, the real price of foreign currency rose by 100 per cent. In addition, the uniform tariff was raised in two steps to 35 per cent in September 1984. As balance of payments stringencies abated, the tariff rate was gradually reduced and reached 15 per cent in early 1988. A further reduction to 11 per cent took place at the end of 1991, in response to the bonanza of foreign exchange which has characterized the Chilean economy since 1988.

Since 1988, there have been pressures towards a real exchange rate revaluation. These have arisen from the country's export success, high copper prices (until recently), strong inflows of FDI, and speculative short-term capital flows attracted by Chile's high interest rates. The monetary authorities have averted a major appreciation through a number of policy changes, including the imposition of reserve requirements on foreign borrowing by banks and on deposits by foreigners in Chilean banks, the introduction of dirty floating within an expanded band, and the switch from the dollar to a currency basket for pegging the central rate. These measures have discouraged unwanted short-term flows and, at the same time, have given certainty to exporters and foreign investors as regards the real value of foreign exchange in the long run.

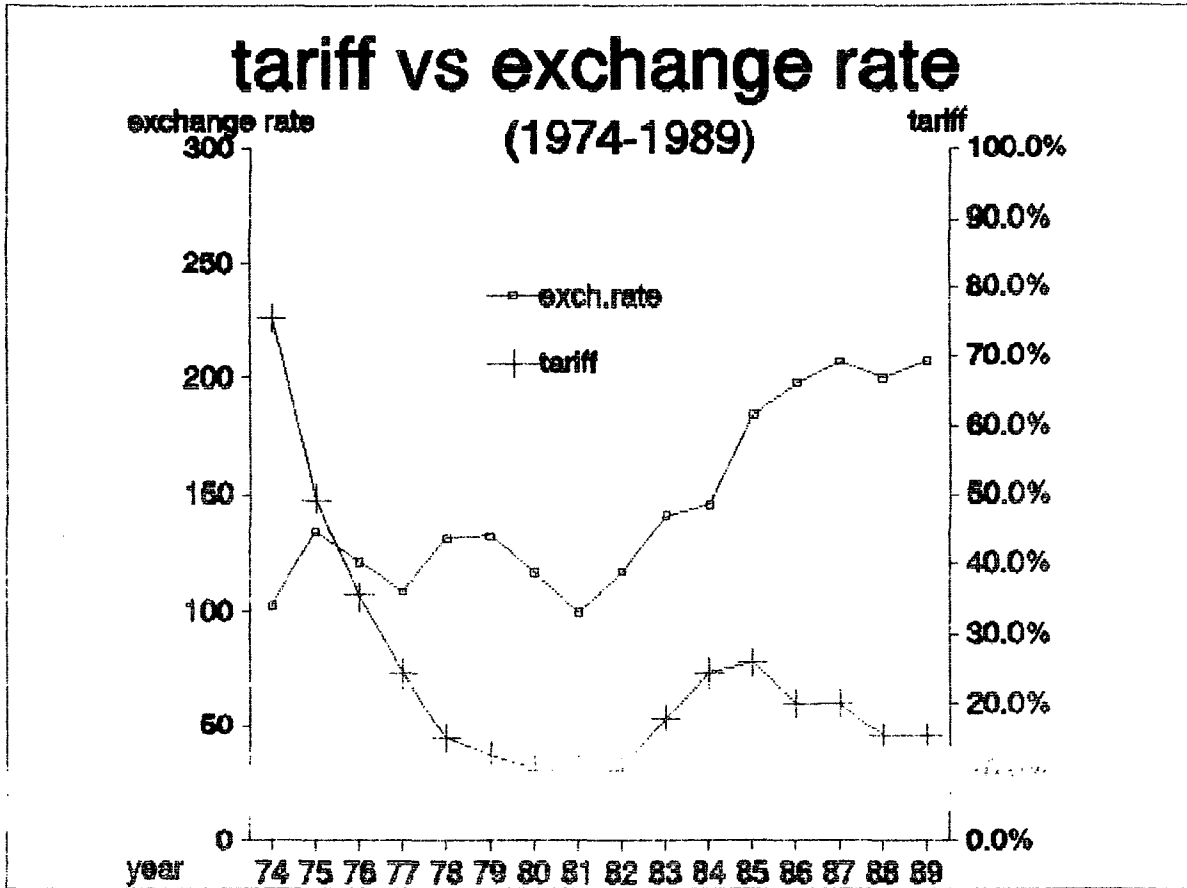
One important deviation from incentive neutrality from the very beginning were the large subsidies given to forestation and reforestation starting in 1974, which were essential for the development of this new export sector. A para-statal venture capital organization was also instrumental in developing the salmon industry, another one of Chile's new export products. Chile has become one of the world's important exporters of this product. Some TNCs now participate in this activity.

After the crisis of the early 1980s, policies became more pragmatic. In the trade policy area, some new measures for promoting exports were taken. These included the adoption of tariff drawback mechanisms and the establishment of a system of "simplified drawbacks", which amount to small subsidies, for exporters of new products.

Financial Liberalization 2/

The situation prior to the liberalization of financial markets was characterized by financial repression (controlled interest rates, high reserve requirements, the allocation of credit according to non-market criteria, and a very small variety of financial assets), isolation from international financial markets, and a very low participation in the domestic market by transnational banks. Between 1973 and 1977, the liberalization of the national financial market was accomplished: interest rates were allowed to be determined by market forces, reserve requirements were gradually eased, nationalized banks were transferred back to private hands, and banks were given greater freedom to operate in various financial markets. Between 1977 and 1979, the internationalization of financial markets was

Figure 1



Source: Ricardo Ffrench-Davis, Patricio Leiva y Roberto Madrid, La apertura comercial en Chile, Estudios de Política Comercial No. 1, UNCTAD, 1991.

gradually carried out: local banks were increasingly allowed to borrow in international markets and make exchange-rate-linked loans in national currency, foreigners were allowed to make deposits in the national banking system, and residents were allowed to maintain deposits denominated in foreign currencies. After 1977, the number and importance of transnational banks operating in Chile grew rapidly.

The crisis of 1981-82 revealed a series of problems in the financial system, including a lack of effective bank supervision, lack of transparency in the activities of banks, an excessive amount of lending to firms related by ownership links with the banks, and an excessive degree of confidence that unrestricted financial openness could have only beneficial effects on the economy. As we have seen, the large capital inflows which followed the opening of the financial sector undermined the effectiveness of the trade liberalization programme. Furthermore, indiscriminate foreign borrowing by domestic banks and on-lending to activities which were either unviable in the long run or which were too concentrated in the non-tradable sector led to the onset of the debt crisis.

The crisis forced the government to take over a good part of the banking system and to assume the foreign debt of the banks. The banks were gradually returned to private hands. In the period following the crisis, some of the policy errors which were responsible for its emergence were corrected, bank supervision was tightened and credit to related firms was prohibited. As already noted, a more realistic exchange rate policy has prevailed since 1983. The problems of excessive foreign indebtedness were corrected by the market: voluntary bank lending disappeared for a good part of the 1980s. When capital flows returned to Chile in 1989, the authorities were in a much better position to deal with a new bonanza of foreign exchange.

Policies Towards FDI 3/

The so-called Decree Law 600 has regulated FDI since 1974. The basic principles of this decree are national treatment for foreign investors, free access to national markets, and the almost complete absence of government regulation with regard to the activities of foreign firms or the sectoral allocation of their resources. Foreign investors are guaranteed the right to remit profits abroad and repatriate their capital after three years. They can choose between the tax régime that applies to national firms and a fixed income tax rate of 49.5 per cent (which is higher than the one which has been applicable to national firms in recent years) for a period of ten years.^{4/} There is also an option of invariability with respect to import duties and taxes on services.

Another way of making foreign investments in Chile is through the debt-equity conversion scheme set up in mid-1985 (chapter XIX of the Foreign Exchange Norms of the Central Bank). Under this scheme, a foreign investor purchases Chilean debt paper at a discount in international capital markets and exchanges it in the Central Bank at the official exchange rate and at its nominal value (minus a discount determined by the Bank) for Central Bank paper, which it can then sell in the domestic financial market in order to make an investment authorized by the Bank. In recent years, investments by foreign mutual funds of Chilean stocks have been authorized to use this mechanism (Desormeaux, 1989). When the scheme was set up, the investment had to remain in the country for a period of ten years and profits could be remitted only beginning in the fifth year. Recently, the greater foreign exchange availability has permitted a relaxation of these restrictions. It should be noted that investments made through Chapter XIX are considerably more regulated than those using DL 600. The former are subject to a case-by-case approval by the Committee on Foreign Investments, while approval of the latter is mostly a formality.

The Contribution of FDI to Structural Adjustment

As can be seen in the accompanying table, FDI has grown very substantially in the period since 1974. In the years since the adoption of the debt-equity conversion scheme, this mechanism for making foreign investments in Chile has been rather important. However, the volume of resources utilizing chapter XIX has diminished very sharply since 1989, mostly because the prices for Chilean debt paper have risen to levels close to par, reducing the incentive for using this modality. The growing importance of FDI in the Chilean economy can be appreciated when it is observed that it now represents over 5 per cent of GDP and accounts for 30 percent of the country's gross fixed investment.

In order to assess the role of FDI in the structural transformation of the economy, it is necessary to look at its sectoral distribution. The sectoral distribution of FDI under DL 600 is quite different from that under chapter XIX. With regard to the former, during the entire period from 1974 to 1989, there were only three sectors receiving important amounts of FDI: mining, with almost one half of the total; and services and industry, with about a quarter each (see figure 2). It should be noted that the category "industry" includes mostly semi-manufactures and some manufactures for export that are closely related to the country's natural resource base. Thus investments in the wood and pulp and paper industries figure prominently among those classified in industry. In the services sector, the main recipients of foreign investment were the banks and the newly-created pension fund management companies.^{5/}

When it comes to investments under chapter XIX, the picture is quite different (see figure 3). The mining sector accounts for a much smaller proportion of total investments (somewhat over one tenth), mainly because the use of chapter XIX was severely restricted for investments in this sector. Investments in the industrial sector are considerably more important (over one third of the total); and one quarter of all investments made under chapter XIX went to agriculture, forestry and fisheries, as compared with negligible amounts under DL 600. Investment in the services sector, mainly in finance, account for a fifth of the total flows utilizing chapter XIX, a slightly smaller proportion than those under DL 600.

Summing up, about three quarters of all FDI made under both mechanisms went to sectors directly related to exports. Investments for the domestic market were negligible. There are some differences in the sectoral distribution of FDI under the two mechanisms. The mining sector figures more prominently in the case of DL 600, and forestry, wood products and pulp and paper were more important in the case of chapter XIX.

What attracted FDI to Chile in this period, and particularly in the 1980s? For one, the legal framework has remained almost unchanged since 1974. Gradually, the welcoming and consistent attitude of the Government towards foreign enterprises came to be regarded as permanent. Chile's strong comparative advantage in a wide variety of natural resources could come to be recognized by TNCs operating in these sectors as attractive investment opportunities. The stability of other policies, particularly macroeconomic policies, in the period after the crisis of the early 1980s also contributed to the positive attitude toward Chile in the international investment community. The commitment of the authorities, since 1983, to policies avoiding significant overvaluation and wide fluctuations in

Table 1

FDI IN CHILE: VALUES AND IMPORTANCE IN ECONOMY, 1974-89

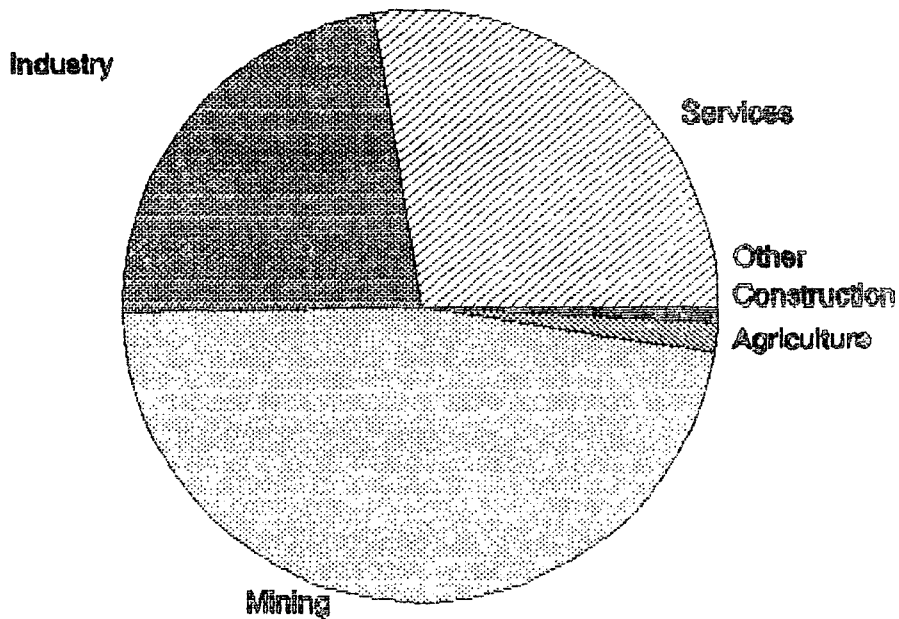
Year	FDI (millions of US\$)	FDI under Chapter XIX (millions of US\$)	FDI/total capital flows (current dollars)	FDI/GDP	FDI/GFCF ^{a/}
1974	-156	-	-112	-1.9	-11
1975	-63	-	-17	-0.7	-4
1976	-117	-	177	-1.2	-9
1977	-26	-	-5	-0.2	-2
1978	168	-	9	1.1	7
1979	248	-	11	1.2	8
1980	251	-	8	1.0	6
1981	375	-	8	1.3	7
1982	343	-	28	1.3	9
1983	142	-	28	0.5	5
1984	137	-	7	0.5	4
1985	161	32	13	0.6	4
1986	390	213	48	1.3	9
1987	1 204	707	128	3.7	23
1988	1 643	856	163	4.6	28
1989	2 159	1 261	155	5.5	30

Source: Behrens, Roberto (1992), Inversión extranjera y empresas transnacionales en la economía de Chile (1974-1989): el papel del capital extranjero y la estrategia nacional de desarrollo, Estudios e Informes de la CEPAL No. 86, LC/G.1678-P, Santiago, Chile.

^{a/} GFCF: Gross Fixed Capital Formation.

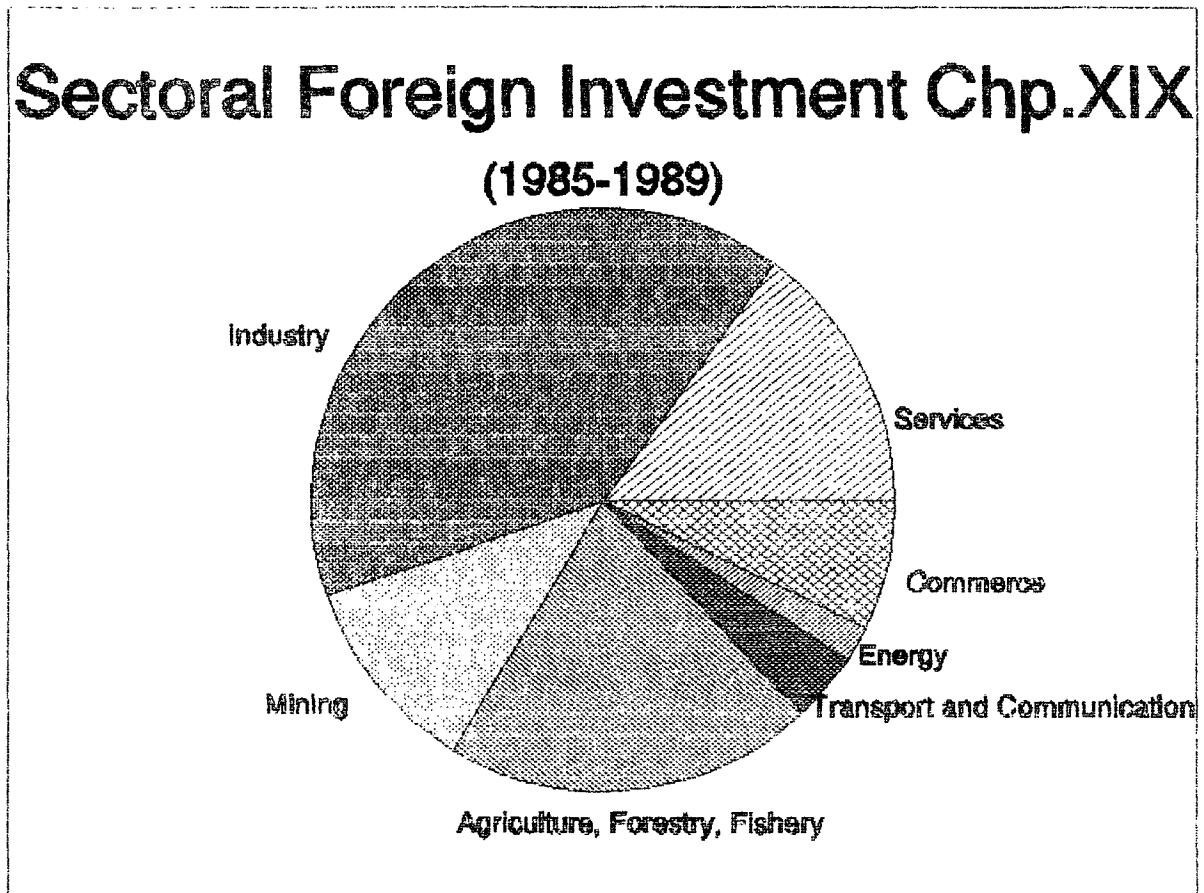
Figure 2

Sectoral Foreign investment L.D.600 (1984-1989)



Source: Roberto Behrens, (1992), Inversión extranjera y empresas transnacionales en la economía de Chile (1974-1989): el papel del capital extranjero y la estrategia nacional de desarrollo, Estudios e Informes de la CEPAL No. 86, LC/G.1678-P, Santiago, Chile.

Figure 3



Source: Roberto Behrens (1992), Inversión extranjera y empresas transnacionales en la economía de Chile (1974-1989): el papel del capital extranjero y la estrategia nacional de desarrollo, Estudios e Informes de la CEPAL No. 86, LC/G.1678-P, Santiago, Chile.

the exchange rate may have also been important in encouraging export-oriented investments since the mid-1980s in sectors such as pulp and paper in which costs in domestic currency are relatively important.

The additional incentives provided by chapter XIX could have brought forth some investments which might not have been made otherwise. This mechanism has given rise to considerable controversy among Chilean economists. Some argue that, without it, much of the same flows of FDI would have taken place (Ffrench-Davis, 1989). Others argue that it did provide an important additionality (Desormeaux, 1989). While it is impossible to know what would have happened to FDI flows in the absence of chapter XIX, the gross figures suggest that there was additionality: the flows of FDI do jump significantly after the scheme was launched. The mechanism may have also served as a device for attracting attention to the advantages of investing in Chile. Whatever the case may be, the scheme proved to be self-liquidating. Foreign investment has not declined with the practical disappearance of chapter XIX. The fact that it is no longer needed as a means of attracting investors to Chile can certainly be considered a sign of its success.

FDI in the manufacturing sector withered since the economic reforms. The reasons are not hard to find. The depressed state of the manufacturing sector for most of the period discouraged investment, both domestic and foreign. In part, the poor performance of output and investment in the manufacturing sector can be considered to be a consequence of the deliberate efforts by policy makers to reorient resources from import substitutes to exportables. But the policy went too far. The destruction of productive capacity in manufacturing deprived Chile of potential exports with greater value added and technological sophistication and which have better prospects than natural resources for sustaining a long-term increase in real incomes.

Economic Reform, FDI and Growth

Economic reform in Chile in the period 1974-89 was intense and without precedent in the developing world. What were its results in terms of economic growth and structural change?

With regard to economic growth, the Chilean economy went through two violent economic cycles (1974-81 and 1982-89) characterized by deep depressions followed by vigorous recoveries. Average per capita growth was barely 1 per cent per annum during both periods. Therefore, in terms of economic growth, the experience cannot be considered a success, especially if it is compared with those of other countries (e.g., the Republic of Korea or Taiwan Province of China) which achieved substantially faster growth rates and where government guidance of the economy was considerably greater. The slow rate of growth of the Chilean economy was accompanied by a very unsatisfactory rate of investment, which never surpassed 20 per cent, compared with the rates of 30 to 35 per cent that are habitual in the dynamic export-oriented economies of Asia. The strong increase in FDI and its growing importance in gross fixed capital formation implies that investment by national companies was even weaker than overall investment. And the mirror image of the strength of FDI, which went predominantly to the export sector, was the weakness of investment in the manufacturing sector.

What the reform did achieve was to reorient the economy towards the export sector and to diversify exports considerably. Exports were the most dynamic sector of the economy. Several new groups of export products emerged or grew very rapidly. But structural adjustment was slow and at high costs.

Until the crisis of 1981-82, exchange rate policy did not support the trade liberalization programme. The currency appreciation that emerged gradually between 1977 and 1982 had very harmful effect on the manufacturing output and investment, from which the sector has not yet completely recovered. The exchange rate appreciated at the same time that the manufacturing sector was being exposed to a radical trade liberalization that took away practical its entire protection from imports. Export subsidies were abjured, and even the adoption of simple tariff drawback mechanisms had to await the more pragmatic attitudes of the 1980s. There was a total absence of deliberate policies of industrial restructuring geared to the reorientation of enterprises towards export markets or of policies aimed at acquiring new comparative advantages in the manufacturing sector. In other words, full confidence was deposited in the virtues of the market to select industries and reorient resources toward them.

Financial liberalization has made the restructuring of the productive sectors more difficult, rather than assisting it. Financial liberalization allowed the large capital inflows of the late 1970s and early 1980s which validated the real exchange rate appreciation. Generally, it has increased the difficulties in managing the exchange rate and orienting monetary policy to national objectives. Recent changes towards a greater pragmatism, which have made for a greater independence of the domestic financial system from international financial markets, are likely to have a favourable impact on exports, foreign investment, and long-term growth.

In general, FDI policies have been quite successful. FDI has grown rapidly and has supported the restructuring of the economy. The debt-equity conversion scheme probably raised FDI flows into the natural resource-based sectors and succeeded in channelling the interest of new foreign investors toward Chile. This policy contributed to the reduction of the debt-export ratio from above 5 in 1984 to below 2 in 1990.

The potential of exports in sectors in which Chile has a comparative advantage based on its natural resources will gradually be exhausted. The Chilean economy must now advance to the next stage of its internationalization. This will involve developing new comparative advantages and will be more difficult to achieve. A more activist set of economic policies will be needed in order to identify sectors with good future prospects, to promote new activities, and to build the physical, human and services infrastructure that a highly competitive economy requires. Policies toward foreign investors might also require some modification. While sticking to policies that welcome FDI, greater efforts need to be made to identify prospective investors in new activities and to attract them to Chile with special incentives. Definitely, a country like Chile, which is and wishes to remain export-oriented, needs to consider its FDI policy as an additional tool in its trade policy kit. With appropriate policies, Foreign investors can make an important contribution to the expansion of Chilean exports in the next stage of the country's development.

Notes

1/ For a detailed account, see Ricardo Ffrench-Davis, Patricio Leiva and Roberto Madrid, (1991), La apertura comercial en Chile, Estudios de Política Comercial No. 1, UNCTAD.

2/ For greater detail, see Enrique Marshall, La apertura financiera en Chile y el comportamiento de los bancos transnacionales, Series Estudios e Informes de la CEPAL No. 78, LC/G.1599-P, 1989, Santiago, Chile.

3/ For greater detail, see Roberto Behrens (1992), Inversión extranjera y empresas transnacionales en la economía de Chile (1974-1989). El papel del capital extranjero y la estrategia nacional de desarrollo, Estudios e Informes de la CEPAL No. 86, LC/G.1678-P, Santiago, Chile and Patricio Rozas (1992), Inversión extranjera y empresas transnacionales en la economía de Chile (1974-1989). Proyectos de inversión y estrategias de las empresas transnacionales, Estudios e Informes de la CEPAL No. 85, LC/G.1677-P, Santiago, Chile.

4/ Since 1985, investments larger than US\$ 50 million can opt for a régime of invariable taxation for a period of up to 20 years.

5/ It should be noted that Chilean FDI statistics classify as FDI in services the investments made by foreign mutual funds of Chilean stocks (the so-called Chile Funds). Technically, these are portfolio investments and not FDI.

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