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The monetary and real effects of the financial opening up of national economies to the exterior

The case of Chile 1975-1978*

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The object of this article is to describe and analyse certain aspects of Chilean short-term macroeconomic policy which have not been sufficiently investigated, placing special emphasis on the financial measures applied from the end of 1973, and more specifically from the first quarter of 1975, when the so-called Economic Recovery Programme began.

The introduction to this paper is followed by a description of the initial situation with which the new macroeconomic policy had to deal. The second part analyses the problems facing the stabilization programme, as well as its characteristics and its achievements, recognizing from the outset that price stabilization was the priority objective of short-term macroeconomic policy in the period under study. In particular, a discussion is made of the links between the stabilization policy, on the one hand, and the external opening up, the evolution of demand for money, and movements in the exchange rate and in the interest rate, on the other.

The third part analyses the implications of an external opening up occurring at a different rate and in a different manner in the real sector as compared with the financial sector of the economy, and studies the relations between exchange, monetary and credit policies in a process of this type, as well as some of the effects it had on investment, employment, resource allocation and the process of concentration of wealth. Finally, the fourth part offers a summary of this study and its main conclusions, perhaps the most important and controversial of which is that the macroeconomic policy applied was not neutral *vis-à-vis* the sectors and groups which had to bear the cost of the stabilization policy and the redistributive effects arising from the way in which the external financial opening up was brought into effect.

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Introduction*

Several countries in the Southern Cone of Latin America have in recent years experienced fairly similar economic and social circumstances, involving political and institutional breaks with the past of varying degrees of abruptness, partly as a result of a very complex economic situation marked by inadequate economic growth, a high rate of inflation, balance-of-payments difficulties, extensive price controls, the existence of large black markets and a drop in output.

In each case the new authorities attributed this situation to the development strategy based on industrialization through import substitution, and to the effect of the numerous 'distortions' which affected the price system.

In these circumstances, in the light of this interpretation and in the context of a new political order, economic policies seeking 'normalization' were introduced with the aim of laying the foundations of a different style of development, guided by a strategy very different from that followed over the past thirty years.

The new strategy emphasizes opening up to the exterior, the free functioning of markets and the stimulation of private initiative; it assigns a 'subsidiary' role to the State, and places emphasis on reducing the government deficit and public expenditure, controlling the means of payment, and ensuring price stability.

The principal features of the short-term economic policy have been an endeavour to reduce the existing macroeconomic imbalances and the allocation of priority —in view of the initial situation— to control inflation and improvement of the balance of payments, as well as external creditworthiness.

The above describes more or less what happened in Argentina, starting in March 1976, in Chile, starting in September 1973 and in Uruguay, starting in September 1974.

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However, there were also some substantial differences, arising partly from the initial situation from which the experiments evolved, and from certain structural characteristics specific to each of these countries. Particular mention may be made in this respect of political and institutional features; those related to the type of export market; the degree to which productive activity was in private or State hands; the speed and completeness with which the economies were opened up to external forces (as regards both real and financial aspects); the predominance of certain economic policy objectives over others (for example, full employment versus price stability); and the approach used and degree of independence and consistency achieved by the technical teams in handling economic affairs.

To a degree, this study falls within a context established by two relatively new global phenomena, one in the international economic field and the other in the application of economic policies by some developing countries.

On the one hand there is the growth in international liquidity and the increasing importance of the international private banks in the recent period, as a result of which private financial credits have been growing in importance in comparison with official external financing, and are beginning to replace direct foreign investment as the main mechanism whereby capital is exchanged between the industrialized countries and the countries at an intermediate stage of development. The emergence of these new characteristics on the international financial scene makes it necessary to highlight, in relation to the past, the specifically economic determinants of supply and demand for external financial resources.

From the viewpoint of the development strategy and economic policy applied by various Latin American countries, especially in the Southern Cone, there is a definite tendency towards external economic opening up. As far as the opening up of trade is concerned, this has attracted a good deal of attention in professional and academic circles. However, there is a lack of studies on the external *financial* opening up proper, and also on its implications for the efficiency of monetary and credit policies and its repercussions on the evolution of domestic prices, the external debt, employment, investment and redistribution of wealth arising from differences in timing or in speed between commercial opening up and financial opening up.

In view of the fact that these events are very recent, that information is relatively scarce and that a comparative analysis of the three cases goes beyond the planned scope of the present study, and also because of the author's greater knowledge of the Chilean case, Chile has been selected as the subject of this study.

I

The initial situation

Between 1971 and 1973 an attempt was made to modify profoundly the distribution of income and wealth in the country. In the long term this implied an alteration of the structure of production, of the mode of operation of the economy and, more broadly, of the type of relations predominating in Chilean society up to that time. As far as economic aspects were concerned, this involved an intensification of the process of agrarian reform and the establishment of an area of social ownership in the spheres of production, finance and marketing.

The economic programme drawn up at that time did not pay due attention to the management of financial variables, but concentrated on an attemp to control the concrete aspects of the process of production and distribution. Because of this, the short-term macroeconomic policy produced such results, at least in some respects, that towards the end of 1973 Chile

was facing an economic situation characterized by numerous severe imbalances, both in the fiscal and monetary sectors and in the balance of payments.

The creation of the area of social ownership and the prices policy applied in it, together with the increasing gap between government expenditure and tax revenues, led to a marked increase in the fiscal deficit. While in the decade 1960-1969 the deficit represented on average 14.6% of expenditure in the sector and 3.3% of gross domestic product expenditure, the corresponding values in the period 1970-1973 were 35.5% and 12.5%. In 1973, the fiscal deficit was equivalent to 55.1% of fiscal expenditure and 23.6% of gross domestic product expenditure (see table 1). In real terms the fiscal deficit in 1973 was seven times as large as in the decade 1960-1969, while fiscal expenditure as a proportion of gross domestic product expenditure stood at double its recent historical share.

Table 1

CHILE: FISCAL DEFICIT, 1960-1978
(Per cent)

As a proportion of	1960-1969	1970-1973	1973	1974	1975	1976	1977	1978
Fiscal expenditure	14.6	35.5	35.1	32.6	11.6	10.0	8.1	4.2
Gross domestic product expenditure	3.3	12.5	23.6	10.3	3.1	2.7	2.3	1.2

Source: Ministry of Finance, Budget Department, *Exposición sobre el estado de la hacienda pública*, Santiago, Chile, January 1979.

Developments in the monetary sector also showed signs of severe imbalances. Whereas in 1960-1969 the average growth rate of private money (M_1) was 37% a year, this figure rose fivefold in 1970-1973, and in 1973 growth in M_1 was 419%. There is no doubt that, in the face of this growth rate in the means of payment, 'monetary' causes were important in explaining the inflationary process which the country was experiencing; inflation reached levels unprecedent in the economic history of Chile. In the period 1970-1973, annual average growth in the Consumer Price Index was 117%,[1] and it reached a rate equivalent to 355% in September 1973, revealing a very serious state of affairs not only because of the very high rates of inflation, but also because inflation did not appear to be under control. In the period 1960-1969, in contrast, the average annual rate of inflation was 25% (see table 2).

[1] Calculated on the basis of the Price Index prepared by the Department of Economics of the University of Chile.

Table 2

CHILE: MONEY AND PRICES, 1966-1973
(Percentage change)[a]

	Inflation[b]	Currency issue[c]	Money[d]
1966-1970	26	48	41
1971	41	133	113
1972	205	174	152
1973	599	462	363

Sources: Central Bank, *Boletín mensual*, various issues, and "Series Monetarias", July 1979. University of Chile, Department of Economics, "Indice de Precios al Consumidor", 1970-1976.

[a] December to December.
[b] Consumer Price Index: 1966-1970 — National Statistical Institute (INE), 1971-1973 — University of Chile, Department of Economics.
[c] Adjusted issue (figures of the Central Bank Of Chile).*
[d] Private sector money (figures of the Central Bank of Chile).
*This is the recorded issue by the private and banking sector, adjusted for various non-monetary items in the Central Bank Balance. See University of Chile, Department of Economics, *Estadísticas monetarias de Chile 1940-1975*, Publication No. 70, Santiago, June 1979, pp. 37-42.

The country's external position, the level of international reserves and capacity to secure external loans had also sharply worsened.[2] As can be seen from table 3, both the trade balance and the current account balance deteriorated in 1970-1973 compared with the average for the 1960s. By the end of 1973 the level of net international reserves was negative to the extent of US$ 231 million, compared with a positive balance of US$ 409 million in December 1970.

Of course, the situation described above was at least partly due to, and was aggravated by, the mode of operation of the foreign exchange, financial and monetary markets, and even the market for real goods and services.

The functioning of the foreign exchange market was characterized by the existence of multiple undervalued exchange rates, prior import deposits, para-tariff restrictions, import bans and other quantitative limitations.

The financial sector, for its part, operated with interest rates held at excessively low levels, high and differential reserve ratios,

[2]It would seem necessary to make a distinction between the actual and potential difficulty of *obtaining* external loans and the ability to disburse them. In fact, as the figures indicate, external financing was *used* fairly easily.

Table 3

CHILE: BALANCE OF PAYMENTS

	1960-1969	1970-1973	1973	1974	1975	1976	1977	1978
	(millions of US dollars)							
Exports of goods	704	1 056	1 304	2 146	1 554	2 109	2 177	2 480
Imports of goods	686	1 170	1 447	2 016	1 708	1 655	2 244	2 917
Trade balance[a]	18	−114	−143	130	−154	454	−67	−437
Current account balance	−135	−236	−288	−211	−491	148	−399	−730
Balance of non-compensatory capital	148	203	242	228	299	235	346	1 351
Balance of payments	25	−132	−112	−45	−275	455	−7	671
Net international reserves (average for the period on the basis of end-of-year figures)	−15	42	−231	−277	−551	−96	−103	515
	(percentage of gross domestic product expenditure)							
Exports of goods	18.2	17.4	19.2	25.6	19.5	24.3	21.8	21.7
Exports of goods (excluding copper) and services	7.8	6.5	5.5	8.0	11.5	13.4	15.0	16.2
Imports of goods	17.7	19.3	21.4	24.0	21.4	19.1	22.4	25.5
Trade balance[a]	0.5	−1.9	−2.1	1.6	−1.9	5.2	−0.7	−3.8
Current account balance	−3.5	−3.9	−4.2	−2.5	−6.2	1.7	−4.0	−6.4
Balance of non-compensatory capital	3.8	3.3	3.6	2.7	3.7	2.7	3.6	11.8
Balance of payments	0.6	−2.2	−1.7	−0.5	−3.4	5.2	−0.1	5.9
Net international reserves (average for the period on the basis of end-of-year figures)	−0.4	0.7	−3.4	−3.3	−6.9	−1.1	−1.0	4.5

Sources: Central Bank of Chile, *Boletín mensual*, December 1976 and May 1979. Ministry of Finance, Budget Department, *Exposición sobre el estado de la hacienda pública*, January 1979.

[a]Defined as exports of goods less imports of goods.

qualitative and selective control of bank credit, and so on. Moreover, the Central Bank offered no resistance to the demands of the government sector and State-owned enterprises, and thus helped to accentuate inflationary pressures.

To this should be added the profusion of price controls in the market for real goods and services, with the resulting effects on the allocation of resources and the general efficiency of the economic system, and on the emergence of parallel (black) markets.

Although the unemployment rate stood below its historical levels (to a large extent because of the rise in employment in the public sector and the area of public ownership), the share of gross domestic fixed capital investment in the gross domestic product expenditure in the period 1971-1973 was 20% lower than in the 1960s. Furthermore, after a growth of 7.7% in gross domestic product expenditure in 1971, it fell to 0.1% in 1972 and 3.6% in 1973.

In view of the circumstances described above, the new authorities set themselves the short-term aim of re-establishing macroeconomic equilibrium, particularly in the financial field.

As a longer-term strategy, the new régime has endeavoured to build up an economy based on the use of the free price system as a mechanism for resource allocation,[3] the progressive reduction of the State's role in the economy and the attribution of a 'subsidiary' role to the State, which must act in such a way as to cause the least possible distortion in the operation of the markets.

Repeated stress has been laid on the need to control inflation and to open up the economy to the exterior. Measures to combat inflation have principally been justified on the grounds of their impact on the transparency and stability of the price system, and accordingly on the allocation of resources. The need to open up the economy has been explained in terms of the size of the international market and the effect of such a step on the competitiveness and efficiency of the Chilean economy.

Consequently, the policies which most merit analysis here —though they were not necessarily applied at the same time, despite the fact that their introduction became fairly systematic[4] from the beginning of 1975 onwards— were the following:

(a) Efforts to control the inflation process by reducing the growth rate of the means of payment and currency issue;

(b) Reduction in the size of the State apparatus, government expenditure and the fiscal deficit, and transfer by the State to the private sector of all those activities (including, of course, productive activities) which the authorities felt that the private sector could carry out efficiently;

(c) Opening up the country to the exterior, especially as regards trade in goods and non-financial services, by simplifying and reducing rules applying to external trade, progressively lowering and standardizing tariffs and, where possible, eliminating all allocation criterion other than the price of foreign exchange;

(d) Unification and forward planning of the nominal exchange rate on the basis of two criteria: the differential between the Chilean and the United States inflation rates, and the evolution of the international reserves of the monetary system;

(e) Liberalization and development of the domestic financial sector, with the criteria of profitability of assets and liabilities of the financial system, and competition between its institutions and intermediaries, becoming the guides for decision-making and action by economic agents. Interest rates would be allowed to move freely, and legal reserve requirements would be reduced and standardized in accordance with general economic policy;

[3]The most notable exceptions have been the labour and foreign exchange markets, where prices have been determined by mechanisms other than the free play of the market. Furthermore, the prices of a small number of goods have been controlled, though apparently at levels very close to those prevailing in the market.

[4]It is not intended to assert that the economic policy has been applied in a manner displaying external and internal coherence and consistency. Nevertheless, despite various changes in emphasis and of priorities both as regards objectives and the means used (for example, inflation and external equilibrium, exchange rate policy, and so on), a basic long-term philosophy has predominated and has generally set the framework for the design of economic policy.

(f) A partial opening up to movements of international capital, principally controlled through the establishment of minimum repayment periods and restrictions on the capacity of the national banking system to borrow and to issue guarantees.

II

The counter-inflation strategy within the macroeconomic policy

The counter-inflation strategy was principally based on the effort to control the rate of growth of the monetary base and money (defined as M_1). This approach was based on the view of the new economic authorities that the magnitude of the Chilean inflationary process by the end of 1973 stemmed from monetary causes which could fundamentally be attributed to the deficit incurred by the public sector and the enterprises in the area of social ownership.

This prompted a sharp restriction of credit from the monetary system to the government sector, which in 1975-1978 became responsible (as regards its budgetary situation in current terms) for a 'disissue' of currency, absorbing in that period 15% of the total issue of the Central Bank (see table 4).

This is consistent with the official medium-term and long-term views on the size and self-financing of the State sector and the need for a sharp reduction in the fiscal sector deficit (see table 1). In these circumstances, the public sector cut back its deficit by reducing expenditure,[5] increasing tax revenues,[6] raising the tariffs of public enterprises and services and, though to a lesser extent, seeking to finance deficits by borrowing domestically from the private sector.

Another important source of finance for the State was the sale of some of its assets; by December 1978 the Corporación de Fomento de la Producción had obtained the equivalent of US$ 585 million in this way. Naturally, this source of income tends to vanish when the process of selling State assets has been completed.

Table 4

CHILE: VARIATIONS IN ADJUSTED CURRENCY ISSUE, 1974-1978

	Adjusted issue	Exchange operations[a]	Domestic credit	Treasury and bond operations
	Absolute values (millions of pesos)			
1974	692	−41	−14	746
1975	3 138	2 336	997	−193
1976	11 027	9 536	3 285	−1 794
1977	14 318	7 453	7 025	−160
1978	16 578	16 747	4 223	−4 392
	Percentage breakdown			
1974	100.0	−6.0	−2.1	107.8
1975	100.0	74.4	31.8	−6.2
1976	100.0	86.5	29.8	−16.3
1977	100.0	52.1	49.1	−1.2
1978	100.0	101.1	25.5	−26.5

Sources: Central Bank of Chile, *Series monetarias*, July 1979; University of Chile, Department of Economics, *Estadísticas monetarias de Chile, 1940-1975*.

[a]Including operations with the private sector and with the Treasury.

Nevertheless, it should be noted that despite the appreciable effort of the public sector to accommodate itself to the requirements of the new economic policy, growth in the monetary base up to the end of 1977 remained extra-

[5]This was accompanied by changes in the breakdown of the expenditure.

[6]Principally through the introduction of a value added tax and strict measures against tax evasion.

ordinarily high for what was termed a 'monetarist' stabilization strategy. Only in 1977 did annual growth in the monetary base fall below the levels recorded in 1971-1973, and even then it remained excessively high, both in absolute terms and in comparison with the periods prior to 1970 (see table 5).

Table 5

CHILE: MONEY AND PRICES, 1966-1978

	Adjusted issue	Private sector money	Consumer price index	Velocity of circulation[a] (number of times per year)
	(Percentage change from December to December)			
1966	60.3	38.9	17.0	12
1967	21.1	25.1	21.9	12
1968	46.0	38.3	27.9	13
1969	41.8	35.2	29.3	13
1970	70.3	66.2	34.9	12
1971	132.7	113.4	41.0[b]	8
1972	173.7	151.8	205.0[b]	8
1973	461.6	363.0	599.0[b]	10
1974	222.5	231.2	375.9	20
1975	312.9	257.2	340.7	24
1976	266.3	189.3	174.3	25
1977	94.4	113.5	63.5	20
1978	56.2	65.0	30.3	17

Sources: Central Bank of Chile, *Series Monetarias, op. cit.; Exposición sobre el estado de la hacienda pública, op. cit.;* INE and Department of Economics, University of Chile.

[a]Defined as the gross domestic product expenditure divided by M_1. These figures correspond to observed values, which are not necessarily the equilibrium values.

[b]*Source:* Department of Economics, University of Chile. For the remainder of the period, the source is INE.

Moreover, in spite of the efforts of the monetary authorities to control the means of payment, it took about five years[7] to reduce inflation to levels close to, though higher than, historical levels.[8]

In terms of the analytical framework in which the economic policy operated, this would seem to be due principally to the relative lack of sound instruments for monetary control,[9] above all because of the embryonic nature of the long-term capital market, which prevented proper open-market operations. This was aggravated by the evolution of the velocity of circulation of money,[10] basically as a result of the creation of very good substitutes for money and the persistence, for a considerable period of time, of high inflationary expectations.[11]

1. *The counter-inflation policy and opening up to the exterior*

Since the difficulty in controlling currency issue lay principally in the exceptional inflow of foreign currency, which accounted for 80% of the cumulative change in the money base between 1975 and 1978, it would appear essential to analyse more thoroughly the repercussions of this change on a group of variables of key importance for the operation, balance and vigour of the economy.

In the first place, it is worth recalling the well known fact that, if the exchange rate is fixed (in the sense that the Central Bank undertakes to buy and sell foreign exchange at a given, though not necessarily constant, price), then as an economy is opened up to external forces (either through the current account, the capital account, or both), domestic issue and money become increasingly endogenous[12] *vis-à-vis* the functioning of the economy. In this

[7]This happened at the end of 1978, though in 1979 inflation revived.

[8]Nevertheless, it should be remembered that international inflation in the last five years has been much greater than that of the 1960s, so that in that regard the greater control recently observed over the pace of Chilean inflation is significant.

[9]A phenomenon which occurs more clearly the more open the economy is to external forces.

[10]This refers to money as defined traditionally (M_1), the growth rate of which was, for most of the period under consideration, regarded as an indicator and guide of monetary policy.

[11]Furthermore, the fact that the economy had been 'indexed', as well as other elements associated with cost pressures, helped to prevent the inflation rate from falling more rapidly.

[12]In the sense that they cannot be controlled by the monetary authority and that in contrast, demand for the means of payment (which depends on the behaviour of individuals, enterprises and banks both at home and abroad) "creates its own supply", basically through movements in the current and capital accounts of the balance of payments.

way the efforts of the authorities to control the nominal supply of money tend to be fruitless, and their field of action is limited to domestic credit.

As is well known, the Chilean production sector was subjected in a rapid and escalating manner to external competition, as a result of the progressive reductions in tariffs (see table 6)[13] and the introduction of a single real exchange rate which, despite these reductions, did not rise appreciably (see table 7).

Table 6

CHILE: NOMINAL TARIFFS, 1973-1979
(Percentage of CIF values)

Date of adjustment	Average tariff	Maximum tariff[a]
1973: at 31 December	94	Over 500
1974: 1 March	90	200
27 March	80	160
5 June	67	140
1975: 16 January	52	120
13 August	44	90
1976: 9 February	38	70
7 June	33	60
22 December	27	60
1977: 8 January	24	50
30 April	22	50
29 August	20	35
December	16	25
1978: March	15	20
June	14	20
December	12	15
1979: June	10	10

Source: Central Bank of Chile.
[a]There are a small number of exceptions to the maximum tariffs, the most important of which relates to motor cars.

Although protection for some sectors which were previously subject to negative effective protection was increased, the average tariff was lowered and standardized, and quantitative restrictions of all kinds were minimized almost to the point of elimination.

As a consequence of this opening up to foreign trade, attempts to control money supply tend, though not immediately, to be cancelled out by movements in the current account[14] or the capital account of the balance of payments. In other words, changes in the level of international reserves result from imbalances in the monetary sector.

The evolution of the capital account of the balance of payments, and in particular that of net inflows of foreign loans to the domestic private sector, especially since the end of 1977, have played a preponderant role in this regard.

Although the external financial liberalization took place more slowly than the liberalization of the real sector of the economy, it came to form the main mechanism through which liquidity in the economy was increased. Part III below contains a more thorough discussion of the special stimulus given to private borrowing abroad. Here we shall briefly analyse the important role played by such borrowing in slowing the decline in the growth of currency issue and thus causing the main burden of the stabilization programme to fall with excessive force on the public sector.

In order to understand the role played by international movements of capital, it is necessary to remember that during the first half of 1975, determination of the interest rate in the domestic financial system was left to market forces. At the same time, steps were taken to ensure a sharp reduction in the previous control —both quantitative and qualitative— on bank credit, by stimulating competition within the financial system.[15] However, because of the desire to control growth of the means of

[13]The lower tariff protection was partially offset by a rise in transport costs during the period.

[14]However, it should be mentioned that, according to the authorities, the commercial opening up had a twofold justification. As far as long-term development strategy was concerned, it would force domestic producers to face up to international competition, while in relation to the counter-inflation policy, although it would restrict the instruments for monetary control over domestic credit, it would, for a given exchange policy, impose a ceiling on the domestic prices of internationally tradable goods and services.

[15]This paper does not analyse the situation within the financial sector as regards the greater or lesser competitiveness, rules of the game, or equality of opportunity as between institutions and intermediaries, both domestic and foreign. In this regard see F. Berger, "La protección efectiva negativa a la industria monetaria y la política financiera externa de Chile", *Cuadernos de Economía*, No. 42 (August 1977), pp. 197-234.

Table 7

CHILE: EVOLUTION OF THE EXCHANGE RATE AND PRICES
Indexes (Average for 1974 = 100)

Period	(1) Index of the nominal exchange rate	(2) Index of wholesale prices of domestic products	(3) Index of wholesale prices in the United States	(4) [(1)(2)](3) Index of the real exchange rate[a]
1974 (average)	*100*	*100*	*100*	*100*
First quarter	52	46	92	104
Second quarter	77	73	96	101
Third quarter	108	115	103	97
Fourth quarter	167	169	106	105
1975 (average)	*595*	*590*	*108*	*109*
First quarter	280	261	106	114
Second quarter	490	452	107	116
Third quarter	700	697	109	109
Fourth quarter	907	946	111	106
1976 (average)	*1 580*	*1 920*	*114*	*94*
First quarter	1 212	1 224	112	111
Second quarter	1 517	1 720	113	100
Third quarter	1 640	2 266	115	83
Fourth quarter	1 950	2 474	116	91
1977 (average)	*2 607*	*3 514*	*121*	*90*
First quarter	2 230	2 900	118	91
Second quarter	2 353	3 392	121	84
Third quarter	2 695	3 744	121	87
Fourth quarter	3 128	4 020	122	95
1978 (average)	*3 828*	*5 097*	*130*	*98*
First quarter	3 520	4 352	126	102
Second quarter	3 778	4 868	130	101
Third quarter	3 953	5 358	131	97
Fourth quarter	4 060	5 810	134	94

Sources: Central Bank of Chile; National Institute of Statistics (INE).
[a]This column probably underestimates the actual real exchange rate, if one takes into account the diversification of Chilean foreign trade and the devaluation of the dollar against other industrial countries currencies. No calculations of the effective exchange rate are published in Chile.

payment, high reserve ratios on deposits were maintained for a substantial period, and this helped to create a marked difference between interest rates for borrowers and for lenders.

As may be seen from table 8, from the second quarter of 1975 onwards extremely high real interest rates for borrowers existed side by side with rates to depositors which, while positive (especially from the second half of 1976 onwards), were much lower than the lending rates. The principal explanation for this, as already noted, lies partly in the high reserve ratios and also in the cost of operations by intermediaries and the profits obtained by the financial system during the period under consideration.[16]

[16]Another variable which would explain the high spread between rates to borrowers and rates to lenders would seem to be inflation, as a result of the fact that, as depositors received a positive real rate, part of the inflation tax would be paid by by borrowers, by paying high interest rates on loans. See R. McKinnon, "La intermediación financiera y el control monetario en Chile", *Cuadernos de Economía*, No. 43 (December 1977), pp. 31-32.

Table 8

CHILE: REAL 30-DAY BANK INTEREST RATES ON PESO DEPOSITS[a]
(Percentages)

	1975			1976			1977			1978		
	Charged	Paid	Margin	Charged	Paid	Margin	Charged	Paid	Margin	Charged	Paid	Margin
January	−3.8	−4.0	0.2	3.7	−0.4	4.1	6.2	1.9	4.3	5.4	4.2	1.2
February	−5.9	−5.5	−0.4	3.9	0.1	3.8	5.4	1.0	4.4	3.6	2.2	1.4
March	−9.6	−8.0	−1.6	1.0	−3.2	4.2	3.8	0.1	3.7	1.5	0.1	1.4
April	−9.3	−6.8	−2.5	2.6	−1.3	3.9	3.9	0.9	3.0	1.8	0.7	1.1
May	2.6	−1.3	3.9	4.8	2.3	2.5	3.8	1.4	2.4	3.6	2.4	1.2
June	1.0	−3.3	4.3	1.6	−0.6	2.2	3.5	1.4	2.1	2.8	1.3	1.5
July	10.9	5.4	5.5	2.7	−0.9	3.6	2.4	0.6	1.8	1.9	0.7	1.2
August	9.4	3.7	5.7	6.0	2.6	3.4	2.8	1.0	1.8	1.8	1.0	0.8
September	8.7	0.3	8.4	3.7	0.3	3.4	2.4	1.0	1.4	2.1	1.3	0.8
October	3.3	−0.4	3.7	4.8	1.3	3.5	2.6	1.3	1.3	3.6	2.7	0.9
November	3.5	−0.2	3.7	8.4	4.6	3.8	5.2	3.8	1.4	4.0	2.9	1.1
December	6.9	2.7	4.2	7.7	3.8	3.9	4.2	2.9	1.3	4.0	3.1	0.9
Annual[b]	15.9	−17.8		64.2	10.8		57.2	18.7		42.6	25.0	

Source: Central Bank of Chile.

[a]Defined as $i_R = \frac{i_N - p}{1 + p}$, where i_N is the nominal monthly bank rate and p is the monthly inflation rate as indicated by the change in the Consumer Price Index.

[b]Annual real rate, calculated by compounding the real monthly rate over the year.

Table 9

CHILE: 30-DAY BANK INTEREST RATES ON US DOLLAR DEPOSITS[a]
(*Percentages*)

	1975			1976			1977			1978		
	Charged	Paid	Margin	Charged	Paid	Margin	Charged	Paid	Margin	Charged	Paid	Margin
January	−6.88	−7.16	0.28	2.88	−1.16	4.04	6.61	2.28	4.33	4.42	3.19	1.23
February	−7.03	−6.35	−0.68	4.19	0.27	3.92	5.21	0.83	4.38	3.28	1.92	1.36
March	−11.60	−10.07	−1.53	7.58	3.26	4.32	14.54	10.48	4.06	1.82	0.43	1.39
April	−13.67	−11.31	−2.36	7.32	3.21	4.11	6.53	3.47	3.06	1.86	0.82	1.04
May	4.06	0.12	3.94	5.48	2.91	2.57	3.89	1.40	2.49	3.40	2.26	1.14
June	6.86	2.27	4.59	5.84	3.53	2.31	2.46	0.36	2.10	3.09	1.63	1.46
July	3.97	−1.18	5.15	18.17	13.96	4.21	2.70	0.85	1.85	2.91	1.71	1.20
August	9.47	3.86	5.61	6.19	2.68	3.51	1.41	−0.28	1.69	3.27	2.39	0.88
September	11.39	2.76	8.63	5.21	1.73	3.48	−2.29	−3.62	1.33	4.06	3.27	0.79
October	1.96	−1.68	3.64	5.61	2.12	3.49	3.23	1.97	1.26	4.67	3.76	0.91
November	2.37	−1.29	3.66	5.80	2.13	3.67	3.52	2.20	1.32	4.53	3.49	1.04
December	3.26	−0.80	4.06	7.22	3.33	3.89	−0.11	−1.33	1.22	4.74	3.85	0.89
Annual[b]	0.39	−27.90		118.53	44.36		58.38	19.57		51.10	32.73	

Source: Central Bank of Chile.

[a]Defined as $i_D = \frac{i_N - i}{1 + i}$, where i_N is the nominal monthly bank rate and i is the monthly percentage change in the nominal exchange rate.

[b]Annual rate, expressed in US dollars, calculated by compounding the monthly rate (expressed in US dollars) over the year.

Table 9 provides data on actual domestic interest rates[17] expressed in (nominal) dollars, in other words the pertinent rates which are comparable with international interest rates. Here it can be seen that, with the exception of 1975, when the rate of devaluation of the peso was almost identical to the nominal bank interest rate to borrowers, real rates in the remainder of the period were extraordinarily high.

The differential between the interest rates prevailing in Chile and those in the main international financial centres (which on various occasions have recorded negative rates in real dollars), together with the excess supply of international liquidity in the industrialized countries, the improvement in the international reserve position of the Chilean monetary system and Chile's creditworthiness, go a long way towards explaining the inflow of foreign exchange to the country during this period.[18]

Mention must also be made of the stimulus given to demand for external liabilities on the part of residents, because of the types of controls affecting international capital movements, which, for persons who had access to external finance, led to substantial monopolistic or quasi-monopolistic profits (see Part III).[19]

As may be seen from table 10, in the four years between 1975 and 1978 net flows of private capital made up 74% of exchange operations and 58% of the cumulative issue during that period.

It should be noted that, while the inflow of external credit, through its influence on the domestic capital market, helps to reduce the interest rate, this requires that there should be no simultaneous attempt to reduce the rate of increase in the means of payment. If mechanisms are applied to reduce the build-up of domestic credit, a situation arises where a substantial part of the effort made by the public sector is nullified by growth in money arising from the balance-of-payments situation.

It should be mentioned that repayment of the official external debt helped to create this situation, since an 'active' net inflow of foreign exchange was needed to make the payments, even though it is not possible to discount the use of international reserves, at least in part, for that purpose.[20] Nevertheless, the foreign exchange required did not have to be generated by the private sector. The Chilean public sector might also have helped to refinance the debt by means of new foreign borrowing, although this was not the option followed, so that the foreign exchange needed to service the external debt had to be obtained through the trade balance or the *private* capital account.

Table 10

CHILE: NET FLOW OF PRIVATE EXTERNAL CAPITAL AND CURRENCY ISSUE

	(1) Currency issue	(2) Exchange operations	(3) Net inflow[a] of private capital	(3):(2) (Percentage)	(3):(1) (Percentage)
	(Annual flows in millions of US$ dollars)				
1975	639	476	236	50	37
1976	844	731	254	35	30
1977	665	346	267	77	40
1978	523	529	783	148	150
1975-1978	2 671	2 082	1 540	74	58

Sources: Central Bank of Chile, *Boletín mensual* and *Series monetarias*.
[a]Gross inflows less amortization and interest payments.

[17]As in table 8, these rates correspond to observed values (as distinct from expected values) of nominal interest rates, of the change in the level of prices and of the evolution in the nominal exchange rate.

[18]This assertion relates to the monetary impact of the inflow of external financial capital obtained by the domestic private sector.

[19]This should not be interpreted to mean that the supply of external credit is perfectly horizontal, at the same level, for all potential users of such finance, but rather that the imperfections which characterize this market were exacerbated by inadequate State controls.

[20]Naturally, the monetary 'impact' of payments on the foreign debt is not unconnected with the way in which the public sector generates the required resources. In particular, cases where the fiscal deficit is reduced should be distinguished from cases of government borrowing from the Central Bank.

To the above should be added the objective of increasing the country's international reserves (which, however, probably grew faster than was desired); this necessarily imposed a very active role on exchange operations within the scheme of monetary emissions, leading to delays in reducing the growth of the means of payment.

2. *The counter-inflation policy and demand for money*

One of the aspects of the economic policy which attracts most attention is the excessively passive attitude of the economic authorities both to managing demand for money and to influencing the community's inflationary expectations.[21] It is well known that the liquidity ratio is determined by the public in general, but the cost of keeping money can nevertheless be affected by the behaviour of the Central Bank. In this regard, the moment chosen to free interest rates,[22] which, in view of the prevailing circumstances, could be counted on to rise to extraordinarily high levels, does not appear to have been in keeping with the counter-inflation policy, both because of its implications for the velocity of circulation (see table 5) of already existing money[23] and because of the impact on demand for international finance.

There can be no doubt that the freeing of the interest rate, in an intensely inflationary context, together with a relatively slow devaluation, stimulated the economic agents to keep their financial assets (in the form of *quasi-money*) in pesos and their liabilities in dollars.[24] Naturally, these two phenomena were inconsistent with a counter-inflation strategy which involved an *attempt* to reduce the rate of growth in (nominal) money, especially as no decisive action was taken on the determinants of the (real) demand for money.

Accordingly, the timing of the sales of State assets and the freeing of the interest rate does not appear very appropriate in the light of the effort made as regards fiscal discipline, which, *inter alia*, contributed to a sharp drop in investment and an extraordinarily large increase in unemployment.

One interesting aspect was only tackled in part; this was the effort to increase demand for money by reducing the reserve requirement on bank deposits and/or by the payment by the Central Bank of adequate interest on the legal reserves maintained by the banking system.[25]

As is well known, the reserve requirement on deposits is equivalent, from the viewpoint of the banks, to a tax on the use of a 'factor of production'. Reducing the reserve requirement amounts to lowering the tax rate, while paying interest on the reserve, in the final analysis, reduces the magnitude of this tax.

Accordingly, by increasing the capacity for making loans or, alternatively, making it more profitable for banks to seek deposits, it may be hoped that measures such as those indicated will further stimulate competition among banks for deposits, which tend to become more attractive assets for individuals and enterprises, thus increasing the quantity

[21]The exceptions —perhaps somewhat belated— appear to have been two revaluations of the peso (July 1976 and March 1977), the establishment of a daily depreciation schedule for the peso starting in February 1978, and the endeavour to 'guide' interest rates in the capital market, which was of very brief duration.

[22]This coincided with a time of extremely high inflation, severe restrictions on public expenditure, and the sale to the private sector of an appreciable number of enterprises with large State shareholdings.

[23]This is due to the fact that the type of financial assets which were becoming most profitable, and which were not previously available to economic agents, did not include those that comprise money as traditionally defined, although this definition was used as a guide and indicator of the expansionary or restrictive nature of monetary policy.

[24]It should also be mentioned that the domestic financial system was liberalized only partially, and this, according to some analysts, was a principal cause of the high spread between interest rates to borrowers and to lenders. See McKinnon, *op. cit.*, pp. 22-57, and "Represión financiera y el problema de la liberalización dentro de los países menos desarrollados", *Cuadernos de Economía*, No. 47 (April 1979), pp. 3-22.

[25]In practice, this latter mechanism operated by reducing the reserve requirement for the following month by an amount equivalent to the interest payable on the reserve maintained during the previous month. Thus the 'payment' of interest did not cause increases in currency issue, as its effect was manifested in the behaviour of the bank multiplier.

of them sought.[26] Of course, this increase should be compared with the rise in currency issue and the probable increase in the value of the bank multiplier arising both from the reduction in the reserve requirement and from an expected decline in the currency/deposit ratio.

Another point which merits emphasis in connexion with a counter-inflation policy based on an effort to reduce the growth rate of the nominal money supply is the need to pay attention to the evolution of the flow demand for money. The more traditional type of monetary analysis takes account only of money as a stock, and it is in this sense that both the supply of money and demand for it are usually studied. A more relevant concept for evaluating the short-term implications of monetary imbalances, however, refers to the flow of supply and demand for money, and the latter corresponds to demand for money over a given period of time.

Either as a consequence of imbalances between the real stock of money sought and the existing stock, or of economic growth, of expectations of a reduction in the cost of holding money, of the probable lower yield from assets used as substitutes for money, of demand for nominal money to replenish the real stock sought, or of a combination of these factors, a given demand will exist for nominal money flow.

If the monetary authority does not meet it, there will be an excess supply of goods and a fall in the rate of economic activity, though even so inflationary pressures will not abate for some time. This would be a possible 'monetary' explanation of the phenomenon of 'stagflation'. According to some authors, the mechanism described above could have provided a fundamental explanation for the Chilean situation in 1975.[27]

Because of the magnitude of the tax represented by inflation[28] at that time, and because the monetary authority insisted on controlling the growth of M_1, there was an excess demand for nominal money flow. This imbalance was reflected in excess supply in the goods market, so that the macroeconomic adjustment occurred fundamentally in the form of a profound economic recession, thus reducing demand for real monetary balances.[29]

The above points to the need to ensure that a counter-inflation programme which is aimed at moderating growth in M_1 should also take into account the evolution of demand for money, especially when the real liquidity of the economy is excessively low.[30] This latter aspect is of great importance since, at least in the Chilean case, there is some evidence that when the cost of holding money becomes excessively high, real demand for money stock becomes very inelastic *vis-à-vis* the inflation rate,[31] whereas this does not, of course, happen with the flow demand for money.

[26] It should be noted that, from the viewpoint of the financial institutions, the payment of interest at market rates on legal reserves is equivalent to a reduction in the reserves, so that the large spread between interest rates to borrowers and to lenders would tend to diminish. If this spread is defined as m and is expressed, like the other variables, per unit of deposit, then $m = i_u - i_p = g + c + e_a i_a - e_l i_l$, where i_u = rate of interest to borrowers; e_l = legal reserve requirement; e_a = actual reserve ratio; i_l = rate of interest applicable to the legal reserve; c = administration and intermediation costs; i_p = interest rate to lenders; g = profit. Changes in i_l and e_l of such a magnitude as to modify the spread m by a given amount do not necessarily have the same impact on the value of the bank multiplier or, consequently, on money.

[27] See L. Sjastaad and H. Cortés, "El enfoque monetario de la balanza de pagos y las tasas de interés real en Chile", in University of Chile, Department of Economics, Faculty of Economic and Management Sciences, Santiago, *Estudios de Economía*, No. 11, first half of 1978, p. 13.

[28] See R. Zahler and E. Budinich, "Financiamiento gubernamental, emisión e impuesto inflación", *Estudios de Economía*, No. 8 (second half of 1976), p. 138.

[29] The attempt to regulate one or other of the determinants of demand for money meant a delay in domestic financial liberalization. As far as the official economic strategy was concerned, the financial reform was apparently of such priority that it was decided to sacrifice the performance of other markets and economic sectors in order not to hold up the evolution and development of the capital market.

[30] In the Chilean case, real demand for money stock dropped sharply until mid-1976, from which date the liquidity coefficient began to rise. For the implementation of monetary policy in the short-term it is very important to be able to determine the evolution of demand for money stock (real) and demand for money flows (nominal), since at different moments in time stock and flow disequilibria of different intensities may coexist, or there may be equilibrium with respect to stock and disequilibria with respect to flows, and vice versa.

[31] When the rate of inflation (actual and expected) is very high, economic agents tend to replace real monetary

3. *Counter-inflation policy, the exchange rate and the rate of interest*

As is well known, in a small, open economy with a non-floating exchange rate there is very close relationship between exchange, monetary and credit policies. The Chilean case fits this description in many respects.

A matter continuously under discussion is what the 'equilibrium' exchange rate should be, and what exchange rate policy would be most appropriate. If it is accepted that the monetary authority should fix the exchange rate instead of letting it float, what criterion should guide forward planning of the exchange rate? A great deal has been written on this matter, and it will undoubtedly continue to be a subject of debate between economists for a long time to come. A recent meeting jointly organized by CEPAL and the Central Bank of Uruguay contributed some interesting ideas (of great importance for the countries of Latin America) to this old discussion.[32] The paragraphs below contain a few additional reflections prompted by Chilean experience in the last five years.

It would seem that forward planning of the exchange rate in Chile was guided by at least two criteria: differences between international and domestic inflation rates, and the level of the country's international reserves.[33] Furthermore, it was sometimes used to help guide expectations of inflation and, through its influence on exports and imports, to secure a desired deficit on the current account of the balance of payments.

This was undoubtedly a case of an attempt to use an instrument to reach various objectives which are not necessarily compatible. In particular, it was not clear whether the exchange rate was a mechanism to be used to control the commercial opening up, or whether its evolution had to be planned in the light of the evolution of the exchange market. For example, during periods of very slow devaluation, and even revaluation, the inflow of short-term capital rose, apparently stimulated by expectations concerning the ratio between the future rate of devaluation and the evolution of the domestic interest rate. In this way, if the exchange rate is used merely as an instrument of monetary control, without combining it with proper planning as regards the relative yields of the different liabilities in the financial system, this may, at least for a time, produce effects very different from those expected.[34] This latter factor is of particular importance because of the close relationship between exchange rate management and interest rate management.

When the exchange rate is indexed, while the interest rate is free and rises to the very high levels it reached in the Chilean case, there is no doubt that this provides an enormous stimulus for the inflow of financial capital. Indeed, attempts to regulate or control this inflow will be fruitless if the interest rate differential between the domestic economy and outside, after discounting expectations of a devaluation (which may include exchange rate risk in parallel markets) is sufficiently attractive.

This, it would appear, was what happened in the Chilean economy. If *total international reserves* are taken as a guide in determining the exchange rate, a situation arises where, as a consequence of the initially restrictive monetary policy, the domestic interest rate rises; as

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balances within their portfolios of assets by other financial and physical assets which offer a higher yield than money. Nevertheless, until money is replaced by other goods as a means of exchange for carrying out transactions, there is a 'minimum' level of real money which, because of its liquidity, is essential for effecting payments in the economy. Thus, over and above a certain (high) rate of inflation, real demand for money stock becomes very inelastic. However, since nominal demand for money flow depends directly on the rate of inflation, among other things, it becomes necessary in a counter-inflation programme to reconcile the evolution of supply and demand for money flows, by taking the appropriate policy measures. See in this regard footnote 30 and Zahler and Budinich, *op. cit.*, p. 142.

[32] *Seminario sobre política cambiaria*, Central Bank of Uruguay and CEPAL, Montevideo, August 1978.

[33] See A. Bardón, "Algunas experiencias de la política cambiaria en Chile (1973-1978)", in *Seminario sobre política cambiaria*, *op. cit.*, and McKinnon, *op. cit.*

[34] For more details see C. Massad, "La paradoja de septiembre", *Estudios de Economía*, No. 5 (first half of 1975), pp. 51-56.

a result, the inflow of external capital is stimulated and the exchange rate is depressed (in relative terms).[35]

This means that the current account deficit and the consequent external borrowing are greater than they would have been if the evolution of the exchange rate had been planned using another criterion, with more rapid devaluations.

In this way the country is placed in a situation where the economic recovery can be slowed down by the continuing restrictions on government expenditure (which ceases to be the 'cause' of inflation, but whose inactivity is an important factor in the slowness of the recovery), together with lower net external demand than would have existed if a different combination of monetary, fiscal and exchange policies had been applied.

In this regard, it is noteworthy that the real exchange rate in Chile, despite the lowering of tariffs and the worsening of the terms of trade which occurred in the period 1975-1978,[36] was on average 2.3% *below* its average value in 1974.[37] In addition, it was very unstable as regards its role in allocating resources for export activities and import substitution, as the currency had been devalued in 1975 and 1978 and revalued in 1976 and 1977.[38] This would indicate that the reduction in tariffs was one of the factors accounting for the marked growth in the country's exports and imports in the recent period, principally through the reduction in the cost of imported raw materials, inputs and capital goods.[39]

The sharp deterioration in the current account balance in 1977 and 1978, and the preliminary projections for 1979, indicate that a more rapid devaluation would be desirable,[40] to generate foreign exchange by means of a smaller current account deficit. In this way greater protection would be granted to the domestic market and, subject to success in modifying expectations of devaluation, the inflow of international capital would be moderated, while there would be still greater stimulation of non-traditional exports, whose real growth rate, *in relation to the tariff reductions*, must tend to decline because of the fact that, once the planned level and structure of tariffs has been reached, the *additional* stimuli to activities which make intensive use of imported goods cease.

In addition, the rate of external borrowing, which in 1978 and 1979 grew much faster than the average for the period, would be reduced. In this regard it has recently been asserted that, in the case of the Chilean economy, foreign borrowing is not of great importance, since most of the loans are contracted by the private sector, thus ensuring the profitability of externally financed projects. In this way, it is argued, servicing of the external debt would be ensured automatically through the efficiency associated with the uses to which it would be put.

However, it would appear necessary to point out that the above argument is excessively simplistic. Because of the considerable recent build-up of external debt, the exchange rate has been held down, making its long-term adjustment more difficult. However, the real cost of servicing the external debt in the future requires not only the generation of domestic saving, but also its conversion into foreign exchange. Accordingly, if important changes occur in the terms of trade, in international liquidity or in domestic economic or institutional circumstances, so that the country does not enjoy the present abundance of foreign exchange, it might be necessary to modify the parity, with corresponding implications for the

[35] If the capital account is freed more rapidly, this latter effect will be magnified.

[36] In the period 1975-1978, the average level of the terms-of-trade index was 77, compared with 85 in 1960-1964, 119 in 1965-1969 and 121 in 1970-1974.

[37] See table 7. Of course, the problem of properly defining what is the 'equilibrium' real exchange rate remains.

[38] Nevertheless, it would seem to have been perceived as fairly stable compared with the evolution of the exchange rate between 1971 and 1973.

[39] Naturally, the sharp devaluation in 1974 and 1975, the initial drop in domestic aggregate demand and the unused export capacity existing at the end of 1973 played a fundamental role in the rise in exports, and especially of non-traditional exports.

[40] Naturally, in view of the openness of the economy, a measure of this nature would have an inflationary impact derived from the increase in the Chilean peso prices of internationally tradable goods and services.

real value of the external debt expressed in terms of domestic resources, and for the social efficiency of the externally financed projects.

As already noted, prior commitments as regards payment of the official external debt imposed strong pressures on the monetary sector. However, it is not clear what procedure for the generation of foreign exchange would be most appropriate —a surplus on the non-compensatory capital account or a smaller deficit on the current account. Perhaps during the period of highest inflation stimulation of the exchange rate might have offered some disadvantages.

Nevertheless, a rate of devaluation persistently lower than the differential between domestic and international nominal interest rates stimulates the flow of international capital to the country, and when this inflow does not finance a current account deficit, but is principally used to build up international reserves, it does not contribute to raising total saving. In fact, for a given level of growth of the quantity of money, external credit actually competes with domestic credit; in contrast, if the inflow of international capital takes the form of a larger current account deficit, external saving is increased.

The combination of devaluation (revaluation) and domestic interest rates are not independent of the inflow of foreign exchange and the creation of base money. Nor are they independent of the degree of substitution and/or complementarity between domestic and foreign saving. It would seem from Chilean experience that the exchange rate is not an appropriate instrument to control the monetary base, especially when it is used in isolation.[41] Insistence on forward planning of the exchange rate using this criterion has important effects on other economic policy objectives, particularly foreign borrowing, complementarity between domestic and external saving, and the allocation of resources between domestic and tradable goods, all of which must be properly evaluated in terms of the objective of stabilizing the level of prices.

III

Opening up to the exterior in the financial field[42]

One aspect of Chilean economic policy which is out of keeping with the general approach which has guided the economic programme in the last five years relates to the opening up of the Chilean economy to international financial capital. It is interesting to note that recent developments in Argentina and Uruguay have been much more liberal in this regard, but at the same time rather more cautious and 'gradualist' as regards the commercial opening up.

Despite the common impression that Chile borrowed a great deal between 1975 and 1978,[43] the empirical evidence indicates that this view should be carefully evaluated. In *nominal* terms, between the end of 1974 and the end of 1978 the country contracted loans totalling US$ 2,137 million, increasing its gross

[41] However, the more open the economy is to external influences, the greater the importance acquired by the evolution of the exchange rate as a *direct* determinant of domestic inflation (not through its influence on the monetary base), together with international inflation and the characteristics of markets for goods and services which are not internationally tradable.

[42] The analysis which follows refers to financial credit rather than to direct external investment, because of the separate determinants of each, the low level of direct investment compared with loans (between 1975 and 1978 external investment accounted for 20% of the net flow of non-compensatory capital, since *private* loans accounted for more than 100% of that flow), and the closer relationship between private loans and the financial aspects of macroeconomic policy.

[43] This may have been due to the fact that during this period external borrowing was in fact strongly *stimulated* by the relatively slow devaluation and the objective of sharply increasing the country's international reserve position and permitting a substantial rise in interest rates to borrowers.

reserves by US$ 1,062 million, giving nominal net borrowing of US$ 1,075 million. This is equivalent to cumulative growth of 25.4% over the net debit balance at the end of 1974, in other words, an annual average rate of nominal net borrowing of below 6% (see table 11). However, it should be mentioned that the net borrowing figures underestimate the 'actual' nominal debt to some extent, since it is necessary to maintain a high level of reserves in order to retain access to external financing.

Table 11

CHILE: EXTERNAL DEBT, 1973-1978
(Millions of US dollars)

Year	(1) External debt	(2) Gross reserves	(1)-(2) Net debt
1973	4 048	401	3 647
1974	4 774	535	4 239
1975	5 263	427	4 836
1976	5 195	816	4 379
1977	5 434	871	4 563
1978	6 911	1 597	5 314

Source: Central Bank of Chile, *Deuda Externa de Chile 1978.*

Note: The external debt figures refer to sums actually disbursed outstanding at the end of each year. They include traditional debt and other external liabilities comprising the International Monetary Fund, suppliers' credits and financial credits to the private sector, as well as short-term lines of credit to commercial banks, the Banco del Estado and the Central Bank.

'Real' net borrowing is usually estimated by deflating the nominal value of the external debt by an index of the unit value of the country's imports. During the four years 1975-1978, if this procedure is used, Chile's real gross external debt fell at an average rate of 0.4%, and the real net debt fell at an annual average rate of 3.9% (see table 12).

However, as has been asserted in a recent study,[44] the methodology set out above suffers from serious limitations, and it seems more appropriate, in measuring the effective debt burden, to deflate it by an index of the terms of trade. This calculation, in the Chilean case, leads to the conclusion that the average annual growth rates of the gross and net debt during the period 1975-1978 reached 27.2% and 22.7% respectively. In other words, real growth in the external debt thus defined, in the last four years, was three times the growth of the nominal external debt.

Furthermore, provisional figures indicate that in 1979, as in 1978, external borrowing showed a sharply increasing trend.

Despite the above, it would have seemed reasonable to expect a much greater inflow of external credits in view of the very high domestic interest rates, the low interest rates on international markets, the abundance of international liquidity and the evolution of the exchange rate in Chile.[45]

Table 12

CHILE: EXTERNAL DEBT, 1975-1978
(Percentage change)

Year	Gross debt			Net debt		
	a	b	c	a	b	c
1975	10.2	−8.3	82.4	14.1	−5.1	88.7
1976	−1.3	−3.2	−8.0	−9.4	11.2	−15.6
1977	4.6	−5.7	16.4	4.2	−6.1	16.0
1978	27.2	17.8	34.0	16.5	7.8	22.7
1975-1978[d]	9.7	−0.4	27.2	5.8	−3.9	22.7

Sources: Table 11.
CEPAL: *Economic Survey of Latin America, 1978.*

[a]Growth rate of the nominal external debt.
[b]Growth rate of the nominal external debt deflated by the index of import prices.
[c]Growth rate of the nominal external debt deflated by the terms-of-trade index.
[d]Average annual growth rate during the period.

[44]See Carlos Massad and Roberto Zahler, "Inflación mundial y deuda externa: El caso del deflactor impropio", in *Dos estudios sobre endeudamiento externo*, Cuadernos de la CEPAL No. 19, Santiago, Chile (English version entitled "World inflation and foreign debt: the case of the improper deflator", CEPAL internal document No. 79-4-978).

[45]It should be remembered that the domestic interest rate in dollars was 60% a year on average between 1975 and 1978.

In order to understand the smaller relative inflow of financial capital to the Chilean economy from an economic viewpoint, three main aspects should be borne in mind.

Firstly, it is necessary to point out that in the first years of application of the new economic policy, the attitude of the international financial community to Chile was very cautious, so that until well into 1977 there were probably substantial limitations on external borrowing on the supply side.

A second consideration is that, while the public sector increased its debt very slowly, the same did not happen with the private sector. As can be seen from table 15 below, in the four years under review the public sector increased its external debt by 17%, while the rise in the private sector debt was 228%. This has important implications in the field of redistribution, as will be indiated below.

A third factor which helps to explain the phenomenon is the set of obstacles and restrictions imposed by the monetary authorities on such external capital as might be appropriated by the domestic financial system.[46]

The most important limitations on the inflow of external credits[47] include those relating to minimum periods for repatriation, and those which restrict bank borrowing in foreign currency in terms of the sums involved (which are tied to the banks' capital and reserves), the speed with which they can be increased (because of restrictions on the flow of borrowing), and the capacity to grant guarantees.[48]

There are also two further aspects of this subject which merit thorough analysis: one relating to the monetary approach to the balance of payments, and the other to the implications for resource allocation and wealth distribution of the type of restrictions imposed on external borrowing. However, the lack of sufficient disaggregated, up-to-date information makes it necessary to conduct the discussion in broad terms, in the form of questions, merely laying down a few general recommendations which, in our view, may be inferred from the Chilean experience.

1. *Financial opening up to the exterior and the monetary approach to the balance of payments*

As already indicated, the economic strategy relating to external financing does not fall squarely within the general lines of economic policy.

It would appear that the economic authorities considered, at least until the middle of 1979, that the so-called monetary approach to the balance of payments has greater validity in the long than in the short term. If dynamic aspects of movements in the balance-of-payments accounts, patterns of adjustment in variables, etc., are ignored, the process of opening up to the international capital market and complete integration into it (together with the liberalization of the domestic capital market, including reforms of reserve requirements, and so on) would, according to the monetary theory of the balance of payments, generate a large inflow of external credit and a very rapid tendency for the domestic interest rate and international rates (adjusted for a certain risk) to become equal. This would furnish a substantial stimulus to investment, especially in construction (one of the most depressed economic sectors in the last five years), and promote a rise in economic activity.

The principal drawbacks of such a measure are connected with the adjustment process, and particularly its possible repercussions on inflation (depending on the degree of commercial opening up and the exchange rate policy adopted, through monetization of the accumulation of reserves), the external borrowing position and the probable drop in the rate of devaluation, with the consequent adverse

[46] See note 15 and D. Tapia, "Apertura al mercado financiero internacional", in *Institucionalidad económica e integración financiera con el exterior* (Santiago, Chile, Instituto de Estudios Bancarios Guillermo Subercaseaux, 1979), pp. 107-130.

[47] There were substantial modifications and simplifications in this regard during 1979.

[48] These limitations are those imposed on demand for loans. It must not be forgotten that, even with total openness, there are also important imperfections, such as market fragmentation, differential guarantees, imperfect information, risk evaluations and quantitative rationing by banks in addition to rationing by price, positive-slope supply of external credit, and so on.

effects on economic activity and employment (particularly in the sectors producing tradable goods).[49]

The main argument cited by the economic authorities against a complete liberalization of the external financial market refers to the potential impact of a massive inflow of external capital on the money supply, and consequently on the stabilization effort.[50] In fact, it is necessary to assess the elasticity of demand for finance *vis-à-vis* the interest rate, identify the monetary repercussions of the measure (including the larger deficit on the current account of the balance of payments) and compare them with the expected evolution of demand for money.

There are very few empirical studies in Chile concerning the behaviour of the market for loanable funds. However, recent experience suggests that a very substantial capital inflow would be required in order to lower the interest rate.[51] If this occurred, it would generate an excess supply of money flows, with equilibrium being achieved in three basic ways.

The first way is adjustment through an increase in *output and/or prices*, principally of goods which are not internationally tradable, with the resulting repercussions on economic activity and/or the general level of prices.

The second adjustment variable would act through the domestic financial market, by means of a rise in *demand for money* (appropriately defined) arising from the possible reduction in the cost of holding liquid balances, and from the rise in the volume of transactions.

Finally, the third means of adjustment is a change in the current account balance of the balance of payments. Naturally, the more open the economy to the exterior, and the greater the trade links with international markets for real goods and services, the more important this variable is. Consequently, it is very likely that a more rapid opening up to external finance would only temporarily generate greater inflationary pressures and a certain improvement in output of non-tradable goods and services. The main result would be a larger trade gap, with a consequent rise in external indebtedness and a fall in levels of activity and employment in the sector producing internationally tradable goods.

However, this last conclusion is closely linked to the exchange rate policy adopted during the external financial liberalization. If the movement of the exchange rate is guided by the evolution of the current account and the external debt, with the currency being devalued more rapidly or more slowly as the current account deficit or the level of external debt increases or declines, there will be a rise in the level of prices, increasing nominal demand for money. The build-up of international reserves, accompanied in this case by the attempt to reduce the growth rate of money, means that external financing replaces domestic credit, without necessarily helping to generate a greater volume of domestic saving. If, on the other hand, the exchange rate policy is guided by the *balance-of-payments* position, a growing accumulation of international reserves would lead to a slower devaluation (or a revaluation), with an increase in the current account deficit and the external debt. In this way, external financing constitutes foreign savings, which, *assuming* a certain level of domestic savings, helps to ensure that the expenditure of the economy exceeds the level of the product.[52]

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[49] Obviously, there are other arguments in favour of not allowing a complete opening up to external capital, such as the political arguments which recognize the implications of a situation where a substantial proportion of domestic capital is in foreign hands, as well as others related to the *imperfections of the capital markets, information costs*, market fragmentation and, above all as regards direct investment, arguments related to the mode of operation of the transnational corporations.

[50] See Tapia, *op. cit.*

[51] This assertion refers to the implications which an inflow of credit would have for external debt, rather than to high interest-elasticity of demand for external finance. The domestic interst rate depends not only on external finance, but also on domestic saving. Domestic saving dropped sharply during the period under consideration. The short term domestic interest rate expressed in dollars in the middle of 1979 was still very high, despite a substantial inflow of capital. In 1975-1978 the inflow of *private* capital (net of amortization and interst payments) was equivalent to 4% of gross domestic product expenditure, rising to 7% in 1978.

[52] Obviously, domestic saving is not independent of external saving: the relationship between them should be specified in each particular case.

It should be noted that increasing external borrowing leads to a 'negative' externality because of the criteria used by creditors in evaluating risks and solvency, so that the social marginal cost (for the country) of external borrowing is greater than the private marginal cost. This is an argument in favour of imposing a tax on the raising of external finance, even when there is complete external financial openness.

On the basis of the interest rate differential, the exchange rate policy followed and recognition of the delayed action of economic policy, it seems clear that more rapid external financial opening up would, in the Chilean case, have led to greater net external borrowing, a fall in the level of activity in the sector producing tradable goods and a rise in domestic liquidity (or a combination of the three effects), thus justifying the authorities' concern to control the degree of external financial openness.[53]

However it cannot be denied that more thorough-going domestic financial liberalization and a stronger devaluation of the peso would have substantially reduced the influence of private capital from abroad, probably stimulating domestic saving and lessening the impact of exchange operations —through the capital account of the balance of payments— on currency issue and the counter-inflation strategy.

Since a decision was taken to move faster towards openness in the trade field than in the financial field,[54] it would seem to be of interest to study this phenomenon, and particularly the way in which external finance was restricted, and its implications for the Chilean economy. These points are analysed below.

2. *Some 'real' consequences of the control of external finance*

One of the most interesting subjects of analysis in the Chilean economic experience is the way in which the external financial opening up was controlled. This is because normally in order to ensure consistency with the remaining measures adopted, it would have seemed natural to expect a total opening up to international capital markets, or alternatively, from considerations of short term macroeconomic equilibrium,[55] the rationing of external credit by price, which was the mechanism governing most of the remaining economic decisions.

However, the procedure adopted[56] involved establishing *de facto* quantitative restrictions on external borrowing,[57] especially in the case of the domestic financial system, which enjoys greatest ease of access to the international capital market. As already noted, the capital and reserves of the financial enterprises limited both their external borrowing and their capacity to issue guarantees, and there was in addition a general limitation on all economic agents as regards the periods of time for which external funds could be borrowed.

The above becomes even more important if it is remembered that, in addition to imposing this type of limitation on external borrowing, the interest rate in the capital market was freed, trade was rapidly opened up, the major part of the process of selling off State enterprises to the private sector took place, and strict discipline was imposed on the State sector and on public enterprises.

These measures led to a sharp rise to extraordinarily high levels in the real rate of

[53] It should also be pointed out that any fall in the domestic interest rate would have produced a stimulus (though probably a small one) to investment, and accordingly to economic growth and employment.

[54] In our view, while it was necessary to regulate the flow of external capital to the country (a phenomenon which would have occurred more easily with a more gradul commercial opening up), the mechanisms used were far from being the most effective and equitable ones.

[55] It is important to note that in very few other areas of the economy was as much concern shown for the short term and the adjustment process.

[56] In June 1979, the restrictions on the contracting of external loans by banks and finance companies were modified.

[57] It is reasonable to argue that, because of the specific characteristics of flows of international financial capital, their volatility, creditors' attitudes and risk assessment, and so on, it is necessary to establish some form of quantitative regulation of the inflow of external credit. However, there are different ways of ensuring this regulation, with different effects in terms of efficiency and redistribution.

interst to borrowers in the financial system,[58] And to a very profound change in the level and structure of aggregate demand and consumption and in the relative prices of goods and factors. The consequences of this situation are to some extent reflected in the investment and unemployment situation in Chile during the period (see table 13). Excessive demand for finance also arose, partly because of the sale of State-owned enterprises, and was aggravated by demand generated on the domestic capital market by public enterprises, which found that contributions from the government, and credits from the Central Bank, were restricted.

Table 13

CHILE: UNEMPLOYMENT AND INVESTMENT
(*Percentages*)

Period	Unemployment rate in Greater Santiago[a]	Rate of investment[b]
1960-1970	6.0	15.3
1971	5.5	14.1
1972	3.8	11.9
1973	4.6	12.0
1974	9.6	13.0
1975	16.2	10.7
1976	16.8	9.7
1977	13.2	10.7
1978	14.3	11.3

Sources: University of Chile, Department of Economics: *Comentarios sobre la situación económica*, 1978, 1979; and *Ocupación y desocupación en el Gran Santiago*, various issues.

[a]Simple average of the rates for March, June, September and December.

[b]Gross domestic fixed capital investment as a proportion of gross domestic product expenditure.

Accordingly, two important consequences arising from the phenomenon under discussion are those relating to the evolution of investment and to the allocation of resources.

There is no doubt that the high rates of interest on loans provide an explanation, even though a partial one, of the depressed level of private investment in the period; to this should be added the drop in public sector investment.[59] In addition, the enterprises which had access to external credit were characterized by their large size and their use of relatively capital-intensive technology, so that there was no guarantee that their investment would necessarily generate high levels of employment or be the most efficient from a social viewpoint.

In this regard it is interesting to observe how in these years, despite some liberalization of the domestic financial market, some of the features of the way the financial system was traditionally managed persisted. Thus, the dual nature of the industrial structure and the distribution of income has tended to be retained, so that a handful of companies receive substantial amounts of credit on preferential terms which they invest in over-capitalized enterprises that are only partially used. In this way this sector generates large incomes, while most of the smaller, fairly labour-intensive enterprises subsist with extraordinarily high financial costs.

It may also be held that, as in the past, such a restricted financial system grants clear advantages to those enterprises which have direct or indirect access to preferential credit (in this case credit from abroad), and to those which can make use of their undistributed profits, either from within the enterprise or from other enterprises belonging to the same economic group. In Chile, a substantial group of enterprises combine all these advantages, and are accordingly improving their competitive position, though this does not necessarily correspond to an increase in their productive efficiency.

It may be deduced from the above paragraphs that the *mechanisms* used to control the flow of external loans to Chile did not promote an adequate level of investment, nor the efficient allocation of it, but instead probably made

[58]The rate to lenders, though it has increasingly been positive, has not been very high because of the wide spread between the rates to lenders and to borrowers.

[59]Public sector investment, which in 1974 represented 12% of gross domestic product expenditure, made up only 6.4% in 1977.

possible a substantial change in the distribution and concentration of wealth.

Because of the form of the attempts made to regulate the flow of external borrowing, conditions were created which enabled enterprises with access to international credit to obtain substantial profits. In other words, because of the way in which the 'import quota' of financial capital was distributed, a profit was generated from the difference between the international and the domestic price of such capital.[60]

There is even evidence that some enterprises engaged in import activities fundamentally because of the attraction of the external credit associated with importing. It has also been alleged that the deficit on the current account of the balance of payments is overestimated because of the incentive for under-invoicing exports and over-invoicing imports, with the difference entered in the form of external credit.

Preliminary, very conservative estimates indicate that the transfer obtained in this way by private enterprises enjoying access to external credit during the period 1976-1978 totalled at least US$ 540 million, rising to over US$ 650 million by mid-1979[61] (see table 14).

[60] It should nevertheless be stressed that, independently of the degree of external financial openness, many imperfections remain in the domestic and international capital markets.

[61] At the end of 1978, the sales value of the State-owned enterprises sold to the private sector during the period stood at US$ 585 million.

Table 14

CHILE: FINANCIAL PROFITS OF PRIVATE ENTERPRISES ENJOYING ACCESS TO EXTERNAL CREDIT

Year	Interest rate			Alternative (1)		Alternative (2)		Alternative (3)	
				Article 14[b]		Non-compensatory capital[c]		Stock of external debt[d]	
	LIBOR	Chile	Differential[a]	Private sector	Profit	Private sector	Profit	Private sector	Profit
	(annual percentage in US dollars)			(millions of US$ dollars)					
1976	6.12	118.53	1.0629	227	121	319	170	641	681
1977	6.42	58.38	0.4554	287	169	381	207	772	351
1978	9.35	51.10	0.3240	750	251	932	326	980	318
1979 (first half)	11.21	42.10	0.1968	500	113	(466)	133	1 569	155
					654		836		*1 505*

Sources: Central Bank of Chile, *Boletín mensual*, May 1979; *Deuda Externa de Chile*, June 1979.

[a] Calculated as the difference between the interest rate on bank loans in Chile, expressed in dollars, and double the LIBOR rate.

[b] Alternative (1) was calculated on the following assumptions: (a) the only sums entered are credits disbursed to the private sector under article 14; (b) they remain in the country for two years; and (c) the amount available per year is equal to half the annual flow. This calculation is undervalued both by reason of the coverage of article 14 (article 15, which corresponds to credit for the private sector, was not included), and by reason of the period spent in Chile, since these credits remain in the country for more than two years; and because no account is taken of the stock of debt under article 14 existing at the end of 1975.

[c] Alternative (2) is based on balance-of-payments data and refers to the movements (net of amortization payments) of non-compensatory capital for private use. In this case the assumptions of alternative (1) were repeated for long term and medium-term capital movements, while only one year of stay in Chile was assumed for 50% of the total short-term credits. For 1979 a movement equal to that of 1978, for all debt periods, was estimated.

[d] Alternative (3) is based on the assumption that the total stock owned by the private sector to foreign sources at the end of the previous year remains in the market for only one year. Neither traditional private debt nor short-term debt is included.

In addition to the above, it should be mentioned that while the private sector was securing its financing to an increasing extent from abroad, the public sector was doing so at a much slower rate. Between the end of 1974 and the end of 1978, private debt increased by US$ 1,449 million, to more than 30% of the country's total stock of debt, compared with less than 14% at the end of 1974. The public sector, on the other hand, which increased its accumulated debt by US$ 688 million, dropped its share from 87% at the end of 1974 to slightly under 70% at the end of 1978.

An examination of debt servicing shows that the net flow of external resources to the public sector in the four years under consideration was *negative* (−US$ 468 million), while the flow to the private sector was US$ 948 million. If, instead of external debt, balance-of-payments figures are used, the situation is even more favourable to the private sector. Moreover, the proportion of borrowing by the public sector during the period 1975-1978 under article 14 of Decree-law 471 (the main provision under which external credits entered the country) was less than 8%, while more than 90% represented borrowing by the private sector.

Table 15

CHILE: EXTERNAL DEBT[a] BY SECTORS, 1973-1978
(*Millions of US dollars*)

	Public debt		Private debt		
	Millions of US dollars	Percentage	Million of US dollars	Percentage	Total debt
December 1973	3 260.2	80.6	787.8	19.5	4 048
December 1974	4 138.2	86.7	635.8	13.4	4 774
December 1975	4 444.6	84.5	818.4	15.6	5 263
December 1976	4 163.8	80.2	1 031.2	19.9	5 195
December 1977	4 067.4	74.9	1 366.6	25.2	5 434
December 1978	4 826.0	69.8	2 085.0	30.2	6 911

Source: Institucionalidad económica e integración financiera con el exterior, op. cit.
[a]The external debt figures refer to sums actually disbursed outstanding at the end of each year. They include traditional debt and other external liabilities comprising the International Monetary Fund, suppliers' credits and financial credits to the private sector, as well as short-term lines of credit to commercial banks, the Banco del Estado and the Central Bank.

It is clear from the above not only that there was probably inefficient allocation with tendencies towards concentration within the domestic private sector, but also that the public sector, including naturally public sector enterprises, found itself in financial conditions which were very disadvantageous compared with those private enterprises which enjoyed access to external credit on the above-mentioned conditions.[62]

Criteria of efficiency and equity dictate that, if it is wished to ration external credit, this should be done through a tax (supplemented as appropriate by other mechanisms) to be collected by the government.[63] Although it is true

[62]It may be held that the private sector borrowed abroad as a way of financing payment of the tax represented by inflation, which was very high during this period. However, this tax fell principally on those economic agents for whom it was most difficult to replace cash or sight deposits by other assets, and on borrowers in the domestic market for short-term capital. It is clear that these categories do not include the major private enterprises with access to international finance, to which they resorted precisely in order to 'evade' the inflation tax.

[63]The measures adopted by the Central Bank in the second quarter of 1979, designed to establish obligatory

Table 16

CHILE: GROSS AND NET FLOW OF EXTERNAL CREDIT[a] BY SECTORS
(Millions of US dollars at current prices)

	1975			1976			1977			1978		
	Gross flow	Debt service	Net flow	Gross flow	Debt service	Net flow	Gross flow	Debt service	Net flow	Gross flow	Debt service	Net flow
Public sector	768	778	−10	545	868	−323	580	1 042	−462	1 529	1 202	+327
Private sector	110	54	56	238	224	14	526	199	327	824	273	551
Total	*878*	832	*46*	783	*1 092*	*−309*	*1 106*	*1 241*	*−135*	2 353	*1 475*	*+878*

Source: Central Bank of Chile.
[a]The external debt figures refer to sums actually disbursed outstanding at the end of each year. They include traditional debt and other external liabilities comprising the International Monetary Fund, suppliers' credits and financial credits to the private sector, as well as short-term lines of credit to commercial banks, the Banco del Estado and the Central Bank.

that the domestic and international capital market is far from perfect, such a measure would drastically reduce the serious drawbacks associated with certain aspects of the way in which the quantitative restrictions on the import of capital were applied.[64]

IV

Summary and final comments

This paper began with a short outline of the macroeconomic situation with which economic policy in Chile since the end of 1973 has had to deal.

There followed an analysis of the foundations of the stabilization strategy which was based on an attempt to reduce the growth rate of nominal money, as traditionally defined.

It was felt that this policy tended to be inconsistent with the progressive opening up of the Chilean economy to the exterior, because of the increasingly endogenous nature of the money supply. Difficulties in controlling base money were exacerbated by the extremely rapid (though partial) liberalization of the domestic capital market, especially in the context of an extraordinary level of international liquidity.

As a result, the stabilization programme appears to have been conceived within the frame of reference of a closed economy, since as the country's economic relations become internationalized, the restrictions on domestic credit, and particularly credit to the public sector, were modified to a greater or lesser extent because of the inflow of foreign exchange. This inflow was also stimulated by the evolution of the domestic interest rate and the

reserve ratios for the inflow of certain types of external credit, are similar to this tax. However, by that time the principal redistributive effect had already been consolidated.

[64] Nevertheless, as pointed out earlier in the text, if the supply of external credit becomes very unstable, it may be necessary to resort to some form of direct control, regulated by the economic authorities.

exchange rate policy followed in 1975-1978.

Consequently, it is considered that an excessive burden fell on the Chilean public sector, with the consequent adverse effects on the level of investment, employment and social expenditure.

Limiting the analysis to a non-floating exchange rate, it was argued that exchange rate policy should not be used as an instrument for controlling the money supply (although it is in fact an important direct determinant of the evolution of domestic prices in an open economy), and it was pointed out that an attempt was made to use and plan an instrument —the exchange rate— on the basis of considerations which were not necessarily mutually consistent, such as the level of international reserves, external debt, expectations of inflation and the differential between domestic and international inflation rates. It is, furthermore, clear that the application of a succession of different exchange rate policy objectives and/or guidelines can lead to excessive instability in the real exchange rate.

The advantages and drawbacks of using the evolution of the current account, or that of the balance of payments, as the most appropriate criterion for exchange rate policy were examined, and it was concluded that, if the aim is that external financing should be channelled so as to ensure the greatest external savings, it seems more desirable that the exchange rate should follow the level of international reserves. If, on the other hand, it is not wished to increase external borrowing, and if appropriate credit measures designed to reduce the inflow of foreign exchange through the capital account are not adopted, external financing will principally be a substitute for domestic credit.

It was therefore concluded that the timing of the external opening up, the domestic financial liberalization and the sale of enterprises to the private sector was inappropriate in view of the effort made by the public sector within the framework of the monetary policy. A more gradual opening up of trade, and measures aimed at directly or indirectly (through credit policy) holding back the flow of capital from and to the private sector, might have permitted a form of monetary planning which placed fewer restrictions on government activity and that of public enterprises.

As regards demand for money, emphasis was laid on the excessively passive role adopted by the economic authorities, the consequences of which were aggravated by the circumstances prevailing when the development of the capital market was promoted. All this helped to delay the reduction of inflation, and helps to explain a substantial part of the process of 'stagflation' suffered by the Chilean economy during part of the period under consideration.

Accordingly, it was suggested that during stabilization processes based on restrictive monetary policies, more emphasis should be placed on the effort to control inflationary expectations and/or on the behaviour and evolution of money substitutes.

This was followed by an analysis of the implications of a process of opening up to the exterior which occurred at a rate and with characteristics which were different in the real sector from those in the financial sector of the economy.

An attempt was made to demonstrate the close relationship between exchange, monetary and fiscal and credit policies in a process of this type. In particular, stress was laid on the need to pay greater attention to the composition of the balance of payments, in addition to its level; and mention was made of the dual role of the exchange rate, both as regards the trade balance and through the effects of expectations concerning its future evolution on international capital movements.

An analysis was then made of the justification —based on counter-inflationary arguments and considerations relating to external borrowing— given for the decision to carry out the external financial opening up in a relatively slow manner. It was indicated that, while such arguments are not without validity, they would carry greater weight if the commercial opening up had also been carried out more gradually; at all events, the magnitude of the inflow of external capital, and the way in which it was restricted, are highly disputable.

A faster planned devaluation, together with a form of domestic credit management

designed to reduce the spread between interest rates to borrowers and to lenders, and an effort to quantify and take appropriate action on the demand for nominal money flow, might have led to a monetary situation such that, without generating inflationary pressures, public sector expenditure and investment would have been spared such drastic reductions.

The mechanisms used to control the flow of capital do not appear to have been those best suited to promoting greater investment or employment or the optimum allocation of resources.

An estimate was made of the total transfers obtained by the domestic private sector which had access to external credit, and stress was laid on their important redistributive consequences, both within the private sector and *vis-à-vis* the public sector.

The analysis leads to the conclusion that the macroeconomic policy applied was not neutral with regard to the sectors and groups which had to bear not only the cost arising from the stabilization policy, but also the redistributive effects associated with the particular form in which the external financial opening up occurred.

It seems clear that, on the basis of criteria of efficiency and equity, a government tax equivalent to a tariff on the import of external credit is a more appropriate mechanism for controlling external financial opening up than the introduction of quantitative restrictions. Such restrictions might become more important if it is felt that the supply of international liquidity available to a country is very erratic or unstable. Indeed, this latter consideration, together with the speed of adjustment of capital movements compared with that of goods, suggests that the external financial opening up offers greater difficulties for the management of macroeconomic policy than the commercial opening up.

Finally, if it is decided to reform the external sector of the economy, the commercial and the financial opening up must be analysed, assessed and implemented in a co-ordinated manner.