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Intelligence Memorandum

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Nota de Archivo: *Summary: This memorandum dissected Allende's economic policies for FY 1971 and concluded that Allende's populist and socialist policies had vastly altered the national economy, that he would most likely be able to maintain his redistributive policies for the remainder of the year, but that he would eventually be forced to take unpopular measures. Source: National Archives, Nixon Presidential Materials, NSC Files, Box 775, Country Files, Latin America, Chile, Vol. V. Secret; No Foreign Dissem. A notation on the first page indicates that the memorandum was prepared by the Office of Economic Research in the Directorate of Intelligence, Central Intelligence Agency. This report is an attachment to Document 246 in Foreign Relations, 1969–1976, vol. XXI, Chile, 1969–1973.*

CHILE'S EMERGING ECONOMIC PROBLEMS

Introduction

1. During Allende's first eight months as President, Chilean economic policy has concentrated on the immediate objective of building political support. Various steps have been taken to this end, notwithstanding their eventual economic consequences. Chile is beginning, for example, to encounter balance-of-payments problems because of sharply increased consumer demand, disruptions of output resulting from nationalization, and the negative reaction of Chile's traditional creditors. The nation had a large cushion of foreign reserves when Allende took office, but they are being depleted rapidly. Allende eventually will be forced to take politically unpopular actions to restrict consumer demand, which could have serious political implications—particularly if he has failed to consolidate his position. This memorandum discusses the economy's developing problems and short-term prospects and assesses the implications for Allende's future.

Discussion

Recent Domestic Economic Trends

2. Allende's policies have largely succeeded in achieving their immediate objectives of reactivating the economy and massively redistributing income, thereby boosting the administration's popular support. CHILE: Cost of Living Indexes A strict price freeze and wage increases ranging from 35% to 45% for most employees have sharply increased consumer demand from its initial post-election slump. Although inflationary pressures are mounting, Allende thus far has held the increase in consumer prices to less than half the rate of recent years (see Figure 1). Because factory owners were reluctant to hire workers that they might not be able to discharge later, unemployment remained fairly high during Allende's first months in office. But the consumer boom and large public spending program recently have sharply reduced the ranks of the unemployed.

CHILE: Cost of Living Indexes

3. Fiscal policy has played a large part in stimulating production and furthering income redistribution. The 1971 budget projects a 60% increase in expenditures in nominal terms. Government revenues, however, are expected to stagnate because of production problems, lower prices, and rising costs in the copper industry and severely depressed profit margins in other industries. As a result, the 1971 deficit probably will equal 25%–30% of expenditures, or 7%–8% of gross national product. Thus far, Allende's budget deficit has been financed almost entirely by Central Bank loans to the public sector—that is, by printing money. The cumulative amount of these loans has increased about tenfold since Allende was elected, and the money supply has jumped by about 70% (see Figure 2).

CHILE: Trends in Money Supply, Central Bank Creditto the Public Sector, and Consumer Prices Figure 2

4. Allende has emphasized rapid expropriation of the remaining large farms and, until recently, even tacitly encouraged peasant takeovers of large and medium-sized holdings. The administration announced that it reached its goal of expropriating 1,000 farms several weeks before the scheduled date of 30 June 1971, when a new agricultural year began. Plantings of winter wheat reportedly are down sharply this year, and the regime has begun to express concern privately about the effect of land seizures and expropriations on agricultural output. Since the seizures also have had an unfavorable political impact, Allende now publicly opposes them. While expropriation has been depressing marketed farm output, rising incomes—especially for lower income groups—have boosted food demand by at least 10%–15%.

5. Nationalization of industrial and commercial firms is destroying investment incentives and disrupting production in many firms, partly by contributing to poor worker discipline. The effects are most pronounced in the copper industry, but other sectors are also being affected. A major stratagem in Allende's takeover of manufacturing firms has been to use labor disputes as a pretext for appointing government managers, under a 1945 statute that prohibits discharging workers. This policy has led to widespread absenteeism, with up to half of the workers reportedly failing to appear in some plants on either Mondays or Tuesdays. In an attempt to control these problems, Allende's Popular Unity coalition has established workers' "vigilance" committees in most factories to report on and intimidate those responsible for production losses.

6. Socialization of the economy—already characterized by extensive state control—has progressed notably under Allende. The final step in fully nationalizing the large US-owned copper mines is now completed, although compensation remains to be determined. The state has bought control of most private banks and taken over almost all the large textile firms and several steel fabricators and gas distributors. In addition, it has nationalized Bethlehem Steel Company's iron ore properties and the nitrate mines owned by Anglo-Lantaro. Allende has used various techniques in the takeovers, including the securing of a constitutional amendment to facilitate copper nationalization, direct negotiations in the case of the iron and nitrate mines, purchases of bank shares (after making continued operations unprofitable for the owners), and appointment of government managers for firms in such industries as textiles and cement. Chile has taken control of something like one-third of the private industry remaining in 1970.

Impact on the Balance of Payments

7. The massive increase in consumer demand resulting from Allende's policies is only gradually being reflected in increased imports, since considerable stocks of finished goods, components, and raw materials were accumulated during the post-election slump in sales. Although imports of such goods have not yet increased appreciably, higher real incomes already have been translated into larger foodstuff imports. During January–April 1971, imports of industrial raw materials and fuel were only about 8% higher than in the corresponding 1970 period, but foodstuff imports more than doubled. Because capital goods imports fell, total imports were only 10% higher than a year earlier.

8. Export earnings are down considerably from 1970, reflecting both lower copper prices and production problems in the large copper mines. The near-completion of copper expansion programs last year was expected at one time to permit a rise of almost 40% in copper output and export volume in 1971. Although production at the new Exotica and Andina mines has

begun, total Chilean output so far is up only about 8% above the 1970 level, inasmuch as output has declined at the other three large mines. Contrary to Chile's expectations, increased export volume has not offset the decline in copper prices.

9. At the same time, traditional sources of foreign credit and investment are rapidly drying up. Short-term and medium-term credit outstanding from US commercial banks has fallen from $225 million to less than $165 million since the Presidential election last September, and US companies not yet affected by nationalization are repatriating funds as rapidly as possible. Chile is finding it very difficult to replace US investment and credit with funds from other Western countries, partly because heavy borrowing by past administrations has given it one of Latin America's largest long-term foreign debts. The total outstanding now approximates $2.4 billion, and debt service obligations (principal and interest) amount to about $300 million this year. Since a sizable portion of this debt is held by West European interests, they may be hesitant to increase the amount at risk. The net result of heavy debt service payments, lower exports, higher imports, and the drying up of foreign bank credit has been a drop in Chile's net international reserves from $345 million to some $200–$225 million during the first six months of 1971, despite receipt of $17 million in special drawing rights from the International Monetary Fund.

Short-Term Prospects

Remainder of 1971

10. Although problems are looming, Allende and his extreme leftist coalition probably will be able to continue their politically expedient economic policies during the next few months. In several respects, the regime may well be able to point to a favorable record of accomplishment for the year. The adverse effect of agrarian reform on farm output will not be fully apparent until the harvest begins in early 1972, and there will be gains in mining and manufacturing output because of recent additions to copper production capacity and the strong demand for consumer goods. Chances thus seem good that the real economic growth rate in 1971 will exceed the 4% average of the past four years. Successful use of price controls and expanded imports to curb inflation so far this year suggests that the cost-of-living will rise less than in recent years, despite the large wage increases and massive increase in the money supply.

11. The main cost of continuing present economic policies for several more months will be a further marked drop in foreign reserves—if copper production remains well below capacity and there is no sustained rise in prices as a result of an extended strike in the US industry. Imports are likely to rise by 15%–20% this year because of expanded food purchases, and export earnings so far are down because copper prices have averaged less than 50 cents a pound, compared with 64 cents in 1970. Under these circumstances, the trade deficit seems likely to reach $100–$200 million. Even if remittances by the copper companies (including compensation for final nationalization) are very small, as seems likely, service transactions stand to add another $100 million or so to the deficit. A substantial loss of reserves thus is in prospect unless the capital account balance is favorable.

12. Everything considered, however, Chile probably will have a net capital outflow of some $50–$100 million in 1971. The backlog of about $400 million in development credits from Free World nations and international agencies is an element of strength and might permit drawings of as much as $200 million this year. But such receipts would merely balance the scheduled debt amortization payments, which Chile is likely to meet during at least most of 1971—although rescheduling may be sought after reserves deteriorate further. In the case of short-term capital, a sizable net outflow seems likely, since US commercial banks anticipate further cutbacks in credit lines to Chile. It is doubtful that these losses can be fully offset by drawings on credits from Communist countries or by West European and Japanese loans and investments. With a 1971 balance-of-payments deficit of some $250 million—the smallest amount that can reasonably be expected barring policy changes or strengthening copper prices—net foreign reserves would drop to roughly $100 million. Such reserves (which would equal only one month's purchases of goods and services) probably are close to the minimum

needed to conduct normal commercial relations.

Next Year

13. Sometime toward the end of 1971 or early in 1972, Chile probably will have to start living more in accordance with its means. If accelerating inflation, black markets, and some form of rationing are to be avoided next year, the government will need to take strong actions such as severely restricting wage increases, raising taxes, and curbing credit expansion. Next year could also see the beginning of a major reallocation of resources from private consumption to investment if balance-of-payments constraints and bottlenecks in production capacity are sufficiently severe and if the regime subscribes to the usual Communist formula for economic development. Corrective measures will be difficult to carry out, however, and will be politically unpopular. The existing dissension among the Allende-led forces may increase as the pleasure of attacking US business and Chile's economic elite gives way to formulating long-term programs for the new "socialist" Chile. Even if economic policy fails to reach such a stage but consists largely of reacting to economic strains, Allende may have trouble building a consensus for action.

14. Unless copper prices rise dramatically or copper production problems are solved rapidly, Chile probably will be forced to curtail imports sometime during the next several months—either through direct controls or substantial devaluation of the escudo, which is now grossly overvalued. Demand for imported raw materials and manufactured goods will soon rise markedly because the stocks accumulated during late 1970 are now largely exhausted. At the same time, Chile probably will need a further large increase in food imports because agrarian reform and peasant takeovers probably will cause a poor 1972 harvest.

15. The Minister of Economics has stated that following the present period of "reactivation," Chile will enter a period of "accumulation"—that is, heavy expenditures for investment such as are found in other Communist countries. Allende's original timetable called for the reactivation period to last until the "Revolution became irreversible," which means until effective political opposition had been eliminated. The reactivation phase is supposed to end in about April 1972, but the rapid depletion of foreign reserves may force earlier action despite the political risks involved.

16. If the economic situation deteriorates seriously, the Allende regime probably will turn to Communist countries for aid to ease problems and minimize the political backlash that basic corrective measures would provoke. We believe, as Chilean Communists reportedly have asserted on several occasions, that some assistance would be forthcoming from these countries, although it is doubtful that the USSR—Chile's most likely Communist benefactor—would supply aid to the extent envisioned by the local Communists. Against the backdrop of continuing heavy support for Cuba, Moscow will continue to move carefully in backing the world's first popularly elected Marxist government and, in fact, has urged Allende to proceed cautiously in implementing his reforms. Even if unwilling to provide a large amount of convertible currency, Communist countries could assist Chile by supplying goods normally purchased in Western markets—such as petroleum, iron and steel, and certain foodstuffs—as well as by extending the customary economic development loans. Such assistance, however, probably would help only partly to meet Chile's pressing need for large amounts of relatively untied capital.