The Political Economy of Trade Reform in Emerging Markets

Crisis or Opportunity?

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INTRODUCTION

Chile is widely seen today as an example of a country that has successfully liberalized its economy, both internally and externally. In the area of trade policy, this process started with the radical reforms undertaken in the mid-1970s. While the broad thrust of Chilean trade policy shows substantial continuity over the last three decades, there have been significant changes in the relative emphasis of that policy. Between 1973 and 1989 it was based almost exclusively on unilateral opening (along with participation in multilateral negotiations), whereas since 1990 it has evolved towards a 'multi-track' approach. The latter combines further unilateral opening with a continued commitment to multilateralism and a growing emphasis on bilateral and regional negotiations. This chapter attempts to explain the evolution of Chilean trade policy since the mid-1970s, in the context of a political economy analysis. This will include the economic rationale for the reforms, as well as the role played by foreign policy considerations, international actors, ideology and interest groups. The evolution of other economic policies, especially those affecting foreign investment, is examined as relevant context for the trade policy reforms.

The second section briefly reviews Chile's economic policies during the import-substitution stage. The third and fourth sections examine the trade and complementary reforms implemented during the period of military rule (1973–89) and under democracy (1990 to the present). The fifth section looks at the impact of these reforms on the overall performance of the Chilean economy. The sixth section identifies the main challenges Chile faces in order to continue benefiting from its integration into the world economy. In the final section some conclusions are drawn, including on the relevance of the Chilean case for other developing countries.

THE IMPORT-SUBSTITUTION PERIOD

The Great Depression of the 1930s had such a negative impact on the Chilean economy[2] that it caused a radical change in its development pattern: from an outward-oriented economy, heavily dependent on mineral exports (nitrate and later copper), to an inward-oriented one, with a focus on industrialization. This shift was reinforced by the scarcity of imported goods caused by the Second World War (Meller, 1996). Over the next decades, Chile resorted to a host of tools in order to promote industrialization, such as exchange controls, multiple exchange rates, high import tariffs, export taxes, import licences, import quotas, import prohibitions, credit rationing and different types of subsidies. This was often done at the expense of the agricultural and mining sectors, which were subject to high taxes and fixed prices.

The United Nations Economic Commission for Latin America (ECLAC), created in 1948 and headquartered in Chile's capital Santiago, was very influential in spreading the paradigm of industrialization through import-substitution across the region. The best known exponent of this 'development from within' paradigm in the Latin American context was the Argentinean economist Raul Prebisch, who was also ECLAC's Executive Secretary from 1950 to 1963.

Fontaine (1993) labelled Chile's socio-economic model prior to 1973 'the redistributive State' and argued that the country was during this period a typical case of a rent-seeking society. From a distributive point of view, the model had a clear pro-urban bias. It favoured urban consumers through capped prices for basic agricultural products. Import-substitution policies also favoured industrial entrepreneurs and workers, especially those unionized, who were also urban dwellers. This pattern was consistent with the political landscape during most of the import-substitution period, characterized by a small electorate dominated by urban voters.

In Chile, the import-substitution model delivered only modest GDP growth, averaging 3.8 per cent a year between 1940 and 1970 (Meller, 1996). It was also characterized by high inflation, chronic fiscal deficits, frequent balance of payments crises and an overgrown public sector. While the share of manufacturing in GDP climbed from 13 per cent in 1925 to about 25 per cent in 1970, large segments of Chilean industry were internationally uncompetitive. Import-substitution was especially unsuitable for a country like Chile with a small internal market. Moreover, it led to the stagnation of the agricultural sector and discouraged exports (Eyzaguirre et al. 2005).

The evidence suggests that the 'easy stage' of import-substitution was over in Chile by the mid-1950s (De la Cuadra and Hachette, 1988; Stallings and Brock, 1993). However, the overall model was by and large maintained since then by successive administrations of different political sign.[3] This is explained in good measure by the fact that most entrepreneurs either adhered to or acquiesced with the concept of a 'mixed economy', in which the State has an entrepreneurial role and also promotes economic activity (Valdés, 1995). This was obviously especially the case for industrial entrepreneurs who benefited most directly from import-substitution policies. As Fontaine argues, the model enjoyed a significant 'social consensus' during the 1940s and 1950s (Fontaine, 1993).

The social consensus gradually began to unravel towards the end of the 1950s, as a consequence of two big trends: a massive increase in the electorate, with the entry of previously disenfranchised segments such as women and illiterate peasants,[4] and a deceleration of economic growth due to the numerous distortions produced by the import-substitution model.[5] The result was that, at the same time that large, poor and mostly rural segments of society entered the political game for the first time, the capacity of the system to deliver on their demands was drastically reduced. This led to a radicalization of the social and political process, especially in the late 1960s, which in turn brought about a hardening of positions by the entrepreneurial movement and the increased unity between its different components.

In particular, the process of Agrarian Reform launched under President Frei Montalva's Christian-Democrat administration (1964–70) sparked a process of defensive organization across the different entities representing the entrepreneurial sector (agriculture, industry, mining, commerce). These left their considerable differences aside and formed a common bloc aimed at the defence of private property (Valdés, 1995).

In 1970 Salvador Allende, from the Socialist Party, took office as President, having obtained only 36 per cent of the votes in the elections that year. He was backed by the Popular Unity left-wing coalition, whose economic programme aimed at a massive collectivization of the means of production. Under President Allende the number and magnitude of distortions in the trade regime (as in the whole economy) grew enormously. The following is a brief summary of the situation at the time of the 1973 military coup (Meller, 1994):

- Import tariffs ranged from 0 to 750 per cent, with an average of 105 per cent.
- 50 per cent of tariff lines had tariff rates above 80 per cent, while only 4 per cent had tariff rates below 25 per cent.
- However, import taxes were only 26 per cent of import value in 1971, as a result of widespread exemptions and special regimes.

- For more than 60 per cent of imports there was a 90-day, non-interest-bearing prior deposit of 10 000 per cent of the imported goods' value.
- Almost 50 per cent of tariff lines required the Central Bank's approval for importing the goods.
- There were eight official exchange rates, with a 1000 per cent differential between the maximum and the minimum.

This system of protection did not result from any specific development objective. The disorganization prevalent not just in trade policy but in economic policy as a whole led to the stagnation of manufacturing production, the disappearance of economic growth, and a severe contraction of the fledgling non-traditional export sector (Agosin, 1999). When in September 1973 the military staged the coup that put an end to President Allende's Socialist experiment, Chile was in the middle of an economic (and political) crisis of enormous proportions. Serious economic mismanagement had brought about hyperinflation (606 per cent in 1973), a massive fiscal deficit (21 per cent of GDP) and crippled productive capacities (Dornbusch and Edwards, 1994).

Before proceeding to the reforms of the military regime, it is important to note that for all its shortcomings, the import-substitution model had some positive aspects. For example, during the 1960s the State promoted research and the creation of human capital in the areas of forestry, fishery and agriculture, all of which would later become leading exporting clusters. The action of the State was also instrumental in developing the physical and telecommunications infrastructure essential for the subsequent export boom (Meller, 1996; Agosin, 1999; Ffrench-Davis, 2003).

THE REFORMS OF THE MILITARY GOVERNMENT

When it seized power in September 1973, the military junta led by General Augusto Pinochet had no definite government project (Valdés, 1995), let alone an economic blueprint. However, it quickly chose a long-term 'foundational' scheme over a 'restoration' one. In other words, the military saw themselves as leading a transformation project for Chilean society, rather than just restoring order and providing the bridge to a civilian administration. According to the military government's Declaration of Principles of March 1974, what was required was 'profound and prolonged actions to change Chilean mentality' (Valdés, 1995).

Although the junta's leaders were all strongly anti-communist, the military's nationalistic tendencies connected well with a protectionist view in economic matters (Fontaine, 1993). Lacking themselves both experience in government and technical expertise in economics, the military resorted to a group of young, liberal economists who had been secretly working since 1972 in an alternative economic programme, in anticipation of Allende's overthrow. The military approached this group partly because of its image of technical competence and partly because of the seriousness of the economic crisis facing the country. Here a brief digression is in order, because that group of economists, who would later come to be known as the 'Chicago Boys', would play a central role in the implantation of a free market model in Chile.[6]

Most of the Chicago Boys were alumni of the Catholic University's Economics Department. All of them followed graduate studies in Economics at the University of Chicago under a cooperation programme between both universities that ran from 1956 to 1964. This programme, known as the Chile Project, was funded by the government of the United States through its International Cooperation Administration (later known as the Agency for International Development, AID). It was deliberately conceived as a means to counter the influence in Chile of the structuralist views then prevalent both in ECLAC and in the national university (the University of Chile). Most Chicago Boys returned to academic life in the Catholic University's Economics Department, which they eventually came to dominate. They also gradually began partaking in debates on economic policy, at the same time as Chilean politics became increasingly polarized.

The group was characterized by a strong *esprit de corps* and by heavily ideological views on social life. All Chicago Boys shared an absolute belief in economic science – in its neoclassical stream – as the best provider of answers to most questions concerning the organization of society. Consequently, they dismissed the role of other social sciences. They also criticized openly not just democratic politics but actually the very notion of politics, which they saw as inherently corrupt and obstructing market forces (Valdés, 1995). Although this discourse made them natural allies of the military, it was inconsistent with their stated aim of building a 'free society' through the reforms of the military government.

During roughly the first two years of the military regime, the Chicago Boys struggled for influence. Not all members of the economic team shared their radical views. In fact, many favoured a more gradualist and less ambitious approach, aimed mainly at correcting the imbalances created under Allende. In the words of the then Finance Minister Jorge Cauas, speaking in July 1974, the goal was to create 'a modern, mixed economy'.

The massive balance of payments crisis of 1975 provided the opportunity for the Chicago Boys to secure the backing of General Augusto Pinochet, with their proposals for a radical adjustment programme. From then onwards, they embarked on an ambitious process of reforms, ultimately aimed at transforming Chile into a truly market-driven economy. The main elements of their platform were liberalization, deregulation and privatization. The Ministry of Finance took on the lead role, especially after December 1976, with the appointment as Finance Minister of Sergio De Castro, widely seen as the Chicago Boys' natural leader.

The First Trade Reform: 1974–1979

Liberalization of the trade regime was essential for the success of the new strategy. The first reform, started in parallel with an adjustment programme aimed at bringing down inflation (Meller, 1996), was radical in its depth and speed. By the time it was completed, in 1979, 'the Chilean import regime could be considered one of the most open in the world. There were no quantitative restrictions, no prohibitions, no anti-dumping or countervailing duties, no subsidies on exports, and a uniform nominal tariff of 10 per cent for all imports except automobiles' (De la Cuadra and Hachette, 1988). Essentially all discretion was removed from Chilean trade policy (Ffrench-Davis, 2003).

This first trade policy reform experienced significant changes along the way, reflecting the tensions between the more pragmatic and the more orthodox positions within the government. In a first stage, from early 1974 to mid-1975, all quotas and official approvals for imports were eliminated, all quantitative restrictions were replaced by tariffs, and the different exchange rates were unified. The simple tariff average was cut from 105 per cent to 57 per cent, although some tariffs still reached 120 per cent. In May 1974 the authorities announced that by 1977 no tariff would exceed 60 per cent. However, this target was subsequently revised downwards, and in August 1975 it was replaced by a range from 10 per cent to 35 per cent, to be achieved during the first half of 1978. The envisaged cuts were implemented faster than had been announced, with the new target range being reached in August 1977. This was seen as the end of the tariff-reduction process (French-Davis, 2003). Up to that point, it was quite an ambitious reform, but one that retained some differentiation in protection levels depending on the degree of sophistication of the products concerned. However, only four months later, in December 1977, the Minister of Finance announced a new tariff reduction plan, aimed at reaching by mid-1979 a uniform tariff of 10 per cent for practically all products. This new target was reached, as foreseen, in June 1979. The more orthodox sector, represented by the Chicago Boys, had clearly prevailed.

The new strategy resulted in Chile's withdrawal from the Andean Pact in 1976.[7] The decision was based both on discrepancies with that bloc's restrictive treatment of foreign investment and on Chile's unwillingness to maintain the high protection levels demanded by the bloc's common external tariff.

By mid-1979 Chile's trade policy had become unique. The 10 per cent protection level was then unusually low among economies at a similar development level, and the lack of any selectivity was (and continues to be) exceptional, even among developed countries. The flat tariff presents several advantages. First, from an economic point of view, it is consistent with the principle of neutrality, or equal treatment to all sectors. The new economic team was of the view that by ostensibly granting the same level of protection to all sectors, the undisturbed market forces would determine the most efficient allocation of economic resources. Second, from a political economy point of view, it minimizes the incentives of individual firms or sectors to lobby for protection. Third, it simplifies customs administration substantially.[8]

Consistent with the new economic strategy, an export promotion agency, ProChile, was set up in 1974, first within the Ministry of Economy and after 1979 under the Ministry of Foreign Affairs. Since its inception ProChile has been an important actor in the efforts to diversify Chilean exports and to increase the number of exporting firms.

The radical character of the first trade reform (as well as of the ones implemented in many other areas) can only be understood within its historical context. First, the economic crisis facing the country was of such magnitude that it provided the right environment for radical reforms. Secondly, the military junta exercised absolute political control. All political parties were outlawed. The National Congress was closed. Left-wing parties were violently repressed, with many of their leaders and members killed, tortured or exiled. The power of labour unions was drastically reduced. Business leaders, most of whom supported the overthrow of Allende, were initially very enthusiastic about the military regime and supported the removal of quantitative restrictions and the early tariff cuts (Stallings and Brock, 1993).[9] Those entrepreneurs who felt negatively affected by the reforms were not heeded. The military granted the economic team isolation from any interest group pressure (Stallings and Brock, 1993). In short, the ideologically-driven Chicago Boys were given the space to implement their policies in almost laboratory-like conditions.

In the multilateral sphere, Chile also broke new ground. In the Tokyo Round of 1973–79, the country bound its entire tariff book, the first GATT member to do so. All tariffs were bound at a flat 35 per cent. The Chilean example of full binding (but not the flat tariff) would be followed by a number of developing countries, especially in Latin America, a decade and a half later in the Uruguay Round.

Investment and Labour-market Reforms

The economic authorities considered it very important to attract foreign investment so that it could flow to the sectors where Chile had comparative advantage, in the context of the new open-economy model. Liberalization of the foreign investment regime was therefore another of the early reforms of the military government. It was explicitly aimed at restoring foreign investors' confidence after the difficulties of the 1970–73 period.

The Foreign Investment Statute, which entered into force in 1974, was instrumental in opening Chile's foreign investment regime. This instrument, still in force, is the main channel through which foreign direct investment (FDI) enters the country. Under its provisions, the foreign investor signs a legally binding contract with the State of Chile for the transfer of capital or other forms of investment and receives a number of specific guarantees and rights. The contract cannot be modified unilaterally by the State or by subsequent changes in the law. However, investors may, at any time, request the amendment of the contract to increase the amount of the investment, change its purpose or assign its rights to another foreign investor.

The Foreign Investment Statute guarantees non-discriminatory and non-discretionary treatment of foreign investors. Therefore, foreign investors enjoy the same rights and guarantees as local ones. It also guarantees investors the right to repatriate capital one year after its entry and to remit profits at any time.[10] Once all relevant taxes have been paid, investors are assured access to freely convertible foreign currency without any limits on the amount, for both capital and profit remittances. The repatriation of all capital invested is devoid of any tax, duty or charge up to the amount of the originally materialized investment. Only capital gains over that amount are subject to the general regulations contained in the tax code. The Foreign Investment Statute allows investors to lock in the tax regime prevailing at the time an investment is made.

Labour market reforms pointed in the same direction as the overall shift in economic policy. Along with the loss of power experienced by labour unions, regulations were made more flexible so as to facilitate the firing of personnel, and there was a reduction in employer-financed pension charges and more generally in non-wage labour costs (Meller, 1996). Labour market reforms also included the removal of entry barriers to some occupations, such as port workers (Fontaine, 1993). However, not all labour-market reforms were in the direction of increased flexibility: a system of wage indexation based on past inflation was put in place in 1973 and retained until 1982.

The 1982 Crisis and the Populist Interlude

Chile's access to international capital markets improved towards the mid-1970s. Starting in 1976, limitations on international capital movements were systematically eliminated, ending with the complete liberalization of international capital flows in 1981.

By the end of the 1970s, there was already talk of the 'Chilean miracle' (Meller, 1996). Average GDP growth was around 8 per cent a year between 1976 and 1981. Exports grew from US$1.3 billion in 1973 to US$4.7 billion in 1980. However, the strong real appreciation of the peso since 1976, along with the reactivation of growth from 1977 onwards and continuing tariff liberalization, led to a large import surge and the emergence of unsustainable current account deficits, financed by private foreign capital.

In June 1979 (that is, at the same point at which the flat 10 per cent tariff was reached), Chilean authorities fixed the exchange rate against the US dollar, in an effort to fight inflation. The same nominal exchange rate was maintained for three years, until June 1982. As inflation came down slowly, this brought about a 31.3 per cent real appreciation of the Chilean peso over this period (French-Davis, 2003), fostered by large capital inflows. This in turn led to a loss of competitiveness for both exporting and import-competing sectors. The tradable sectors of the economy contracted, while the non-tradable ones expanded.

The way in which the domestic financial markets were liberalized aggravated the situation. The 1975 reforms included the privatization of banks, the elimination of ceilings on interest rates, the reduction of the compulsory reserve requirements applicable to banks, and the elimination of all restrictions on credit. At the same time, barriers to entry into banking and financial activities were sharply reduced. Moreover, prudential regulation of banks and other financial institutions was weak. As a result, the financial sector grew enormously, financial operations replaced real investments, and interest rates soared from negative levels to extremely high levels in real terms (Agosin, 1999). This hit both the exporting and import-competing sectors, already affected by the real overvaluation of the peso.

When the debt crisis arrived in 1982, the Chilean economy was the worst hit in Latin America (French-Davis, 2003). Gross Domestic Product dropped by 14.1 per cent, while official unemployment reached 26 per cent (Meller, 1996). As foreign capital dried up, the authorities reacted to the need to generate current account surpluses to service the external debt by successive devaluations that continued well into that decade. The Chicago Boys fell from grace and were replaced by new economic authorities with more heterodox views.

Between 1982 and early 1985 Chile experienced a populist interlude. The government adopted a number of unorthodox measures. Among the most visible was the intervention in a large part of the banking system in January 1983, effectively rescuing those banks from bankruptcy. Moreover, the Central Bank, which would only become independent in 1989, purchased risky portfolios and set a preferential exchange rate for debts in dollars, thereby sheltering those debtors at least partially from the devaluation of the peso.

In the area of trade, there was a partial reversal of the previous reform. Tariffs were raised to 20 per cent in March 1983 and to 35 per cent (the maximum level bound in the Tokyo Round) in September 1984.[11] In addition, temporary tariff surcharges were authorized in 1982 for sectors in special difficulty (mostly industrial ones), and a mechanism to compensate for external price instability – the price band system – was introduced in 1984 for wheat, sugar and vegetable oil. However, the flat tariff policy remained in place (with the exception of the price band system), and there was no recourse to quantitative restrictions.

The tariff increases were aimed at generating additional fiscal revenue at a time when the international price of copper was low, but they were also a response to mounting social pressures. After 1982 opposition groups, although formally proscribed, began organizing massive rallies to protest against the deteriorated economic and social situation, and in favour of a return to democracy. The survival not just of the Chilean free market experiment but even of the military regime itself was seriously questioned (Fontaine, 1993). Moreover, the measures adopted in favour of the financial sector were resented by other entrepreneurs, who were experiencing massive bankruptcies. These business sectors thus became much more vocal than in the past, demanding more active government action to encourage economic recovery (Stallings and Brock, 1993; Campero, 1992; Valdés, 1995). Increased tariff protection was part of the government's answer.

Not all business associations favoured the tariff increases. In fact, by 1984 the main ones had come to be dominated by exporters. These included the National Agricultural Society (where the traditional grain producers were gradually replaced by export-oriented fruit entrepreneurs), the National Mining Society (a traditional export sector in Chile), and the National Chamber of Commerce (dominated by importers). Opposition to free trade was led by some segments of the manufacturers' lobby *Sociedad de Fomento Fabril* (SOFOFA) and by representatives of small and medium enterprises (Fontaine, 1993).

In 1982–83 the Chilean economy faced both internal and external disequilibria. The internal disequilibrium had to do with the very high unemployment rates and the deterioration in workers' wages. The external one had to do with the scarcity of foreign exchange due to the heavy burden of servicing the external debt.[12] After some hesitation, the authorities chose to reduce the external imbalance even at the cost of aggravating the internal one. The political logic behind this decision seems to have been that the military could control domestic unrest by sending soldiers into the streets, but had no leverage to prevent multilateral financial institutions and international banks from cutting the provision of credit to the country. It was therefore decided to 'invest in reputation' by following a non-confrontational strategy vis-à-vis foreign creditors (Meller, 1996).

From 1983 Chile entered into several adjustment programmes with the International Monetary Fund. The Fund identified substantial reduction of the external debt as Chile's most urgent priority. To that effect it prescribed a quick reduction in the current account deficit, to be achieved through restrictive monetary and fiscal policies. The IMF also prescribed a strategy of growth based on the expansion of exports, whose proceedings would allow an orderly servicing of the debt (Meller, 1996).

The Second Trade Reform

The reversal of the trade opening of the 1970s was short-lived. Once the external disequilibrium was reduced, a new economic team led by Hernán Büchi launched the second trade reform in 1985, in line with IMF prescriptions. There was a drastic initial reduction in tariffs from 35 per cent to 20 per cent in just four months, with a further reduction to 15 per cent in January 1988. These tariff reductions were supported by the majority of Chile's business associations, thereby reflecting the ascendancy of a free trade constituency within Chile's business sector.

A key difference with the first reform was the continuous real depreciation of the peso that took place from 1982 to the end of that decade, compensating for the tariff reductions and improving the competitiveness of both exporting and import-competing sectors.[13] This was facilitated by the abolition in 1982 of the mechanism of automatic wage indexation according to inflation that had been put in place in 1973. This resulted in real wages falling by nearly 20 per cent between 1981 and 1987 (Meller, 1996), thereby countering the effect of the successive nominal devaluations on the price level.

From the mid-1980s several mechanisms aimed at promoting non-traditional exports were put in place. The general drawback, introduced in 1988, allows all exporters to be reimbursed for import duties paid on imports incorporated or consumed in the production of exported goods. The simplified drawback, introduced in 1985, was targeted at 'non-traditional' exports (less than US$ 7.5 million a year at the time). It established a refund equivalent to a percentage of the value of a company's exports of a given product (up to 10 per cent), depending on the country's total exports of that product (the higher the country's total exported value, the smaller the refund in percentage terms). This mechanism, which benefited mostly industrial products, could on some occasions have an export subsidy component, as there was no link between the refund and the imported content of exported items (Agosin, 1999). Both drawback programmes are still in force, although the simplified drawback was modified and reduced as a result of Chile's commitments under the WTO Agreement on Subsidies and Countervailing Measures.

The Automotive Statute, which entered into force in 1985, allowed the exemption of customs duties on imports of vehicles for assembly in Chile, to the extent that they were offset by exports of domestic components of an equivalent value, within a period of 12 months following the importation. This provision was among the types of practices prohibited by the WTO Agreement on Trade-Related Investment Measures and was eliminated in 2003.

Starting in 1987, and with a view to promoting technological innovation and stimulating the purchase of capital goods, Chile also allowed for the deferred payment of import duties on imports of capital goods for up to seven years.[14] Moreover, there could be a partial or total remission of the amount due on the deferred import duties if the company concerned had used the capital goods to produce exports. These debt reductions amounted in effect to export subsidies. They were therefore phased out gradually, starting in 1998, as a consequence of Chile's commitments under the WTO Agreement on Subsidies and Countervailing Measures.

ProChile, the State's export-promotion agency, also began to play a more active role in the 1980s. Its main activities include disseminating information on foreign markets, promoting Chilean exports through generic publicity and participation in international fairs, and working to resolve administrative problems faced by exporters through its network of offices abroad.

In short, Chilean trade policy, as indeed the management of the whole economy, presented during most of the 1980s a much more pragmatic, less orthodox character than prior to the 1982 crisis. This was reflected in the deliberate efforts made to preserve a high (that is depreciated) real exchange rate, as well as in the granting of different types of export incentives and of product-specific, temporary protection via surcharges. Real interest rates were reduced substantially as a result of Central Bank intervention, from an average of 38 per cent between 1975 and 1982 to 13 per cent in 1983–85 and 8 per cent in 1986–88 (Ffrench Davis, 2003). This contributed to a more favourable environment for the productive sectors and therefore for economic recovery. In the words of a sympathetic observer, the key to the success of Chile's economic policies in the second half of the 1980s rested in their 'pragmatic orthodoxy' (Fontaine, 1993). This stands in contrast with what has been termed 'the naive phase' of reforms, from 1974 up to the 1982 crisis (Valdés, 1995; Eyzaguirre et al., 2005).

The Trade Reforms of the Military: Overall Assessment

Chile was an early reformer, in trade policy as in other areas. It began implementing autonomously most of the 'Washington Consensus' reforms a decade before the debt crisis gave the IMF and World Bank the leverage to push those reforms in other Latin American countries. Moreover, as it has been widely noted, its reforms predated the 'neoliberal revolutions' of Thatcher in the United Kingdom and Reagan in the United States.

During the period of military rule Chile experienced two separate trade reforms, with one interlude (and partial reverse) in between. The first reform was more ambitious than the second one, but less successful. The lack of coherence between trade and macroeconomic policies, as well as the lack of sound regulation in the financial sector, led to economic collapse and the brief reversal. Moreover, an important part of the existing manufacturing capacity in 1974 was destroyed, rather than being re-oriented towards the exporting sector. Agosin (1999) and Ffrench Davis (2003) have noted that the period corresponding to the first trade reform was characterized by exchange rate instability (and since June 1979 by a strong real appreciation of the peso), very high real interest rates, depressed domestic demand following the 1975 recession, and high unemployment. Against this background, Ffrench-Davis argues that the first trade reform was too fast and too deep. Many entrepreneurs, used to decades of import substitution and government-fixed prices, struggled to make the right decisions in the context of a rapidly liberalized economy. On the positive side, the first reform was instrumental in eliminating the strong anti-export bias of the economy before 1973, and in re-directing resources towards the country's sectors of comparative advantage.

The second reform was much more successful than the first one in promoting export-led growth and the diversification of Chilean exports away from copper. Between 1985 and 1990, exports grew at an average 16.9 per cent per year (Meller, 1993). They benefited from a favourable exchange rate, lower real interest rates, a much more activist trade policy, the existence of substantial spare capacity in the form of a vast pool of unemployed or underemployed labour, and very favourable terms of trade between late 1987 and 1992. Agosin (1999) and Ffrench-Davis (2003) argue that the simplified drawback programme was instrumental in increasing both the number of exported industrial products and the value of those exports.

A few figures illustrate how successful the trade reforms of the 1970s and 1980s (and other associated economic reforms) were in inducing export growth. Exports climbed from US$ 1.1 billion in 1970 (16 per cent of GDP) to US$ 8.3 billion in 1990 (34 per cent of GDP). An important diversification also took place: the share of copper in Chilean exports fell from 80 per cent in 1970 to less than 45 per cent in 1990, although in aggregate Chile's exports continue to be overwhelmingly concentrated in natural resources. Export success stories such as wine, salmon and fruit date to the second half of the 1980s, along with the emergence of a new generation of Chilean entrepreneurs with a global outlook. In sum, the reforms of the 1970s and 1980s laid the foundations for the export-led growth that Chile has experienced almost without interruption since the mid-1980s.

In contrast with its good external performance, Chile's growth record in the 1974–89 period was quite poor: at an average of 3 per cent a year, it was below the 3.8 per cent average of the import-substitution era. Chile also presented a very erratic growth pattern, including two major recessions, in 1975 (with a drop in GDP of 12.9 per cent) and 1982 (drop in GDP of 14.1 per cent), but also two periods of average GDP growth above 6 per cent (1976–81 and 1985–89). The main reason for the country's poor growth performance under the military was the low levels of investment: between 1974 and 1989, investment accounted on average for only 15.6 per cent of GDP (Ffrench-Davis, 2003).

The reforms and adjustment under the military had a big social cost, especially in the years following the 1982 crisis. Unemployment was at double-digits during practically the whole period of military rule, topping at 31.3 per cent in 1983 and staying at effective levels above 20 per cent between 1982 and 1985. Real wages fell by about 20 per cent between 1981 and 1987. In the same period, per capita social spending fell between 6 per cent and 12 per cent, depending on the item (Meller, 1996). Many social indicators worsened markedly.[15] Poverty reached 45 per cent of the population in 1987, several years after the collapse of 1982–83. Income inequality also increased significantly.[16]

The pain from the adjustment process of the 1980s was far from evenly spread. On the one hand, the severe contraction of per capita social spending hit especially hard the poorest and most vulnerable segments of society, which rely disproportionately on the public provision of health, education, housing and – ultimately – a social safety net. On the other hand, the economic authorities strayed from laissez faire on several occasions to subsidize privileged, mostly upper income, groups. Meller (1996) illustrates this by pointing out that while 600 000 people received an unemployment subsidy equivalent to 1.5 per cent of GDP, less than 10 000 debtors in dollars received support equivalent to 3 per cent of GDP. A further 400 000 unemployed did not receive any unemployment subsidies.

The handling of macroeconomic policy during the years of military rule is also widely seen as deficient, especially in the 1974 to 1985 period (Eyzaguirre et al., 2005; Agosin, 1999; Meller, 1996). This is particularly evident in the failure to bring inflation down to single-digit levels.

TRADE REFORMS UNDER DEMOCRATIC RULE: 1990–2005

After winning the December 1989 elections, Patricio Aylwin took office in March 1990 as Chile's first democratically elected President after almost 17 years of military rule.[17] The broad centre-left coalition he led, the Concertación, has been in power without interruption until today, winning the Presidential elections of 1993, 1999 and 2005, as well as all parliamentary and municipal elections.[18]

The successive democratic governments have faced the challenge of both achieving dynamic economic growth and spreading its benefits more evenly across society. This was a major challenge, considering the enormous social frustration accumulated during both the closed-economy period and the military regime (Eyzaguirre et al., 2005).

The new economic authorities – most of them trained in the United States – chose to stick to the market-economy, outward-oriented model. This had to do with a number of factors. First, the economy had been growing by more than 6 per cent a year between 1985 and 1989, with exports growing even faster and unemployment finally coming back to a single-digit figure. Second, by the early 1990s there was widespread and vocal support for the model among Chile's business sectors, which made even a partial reversal almost inconceivable. An influential 'free trade constituency' had emerged among entrepreneurs, made up – among others – of exporters in booming sectors such as salmon, wine and agro-industry, as well as of Chilean firms interested in investing in other Latin American countries. Third, the main parties in the new ruling coalition, and their technocratic elites, had gone through their own processes of reassessing the role of markets during the 1970s and 1980s. These processes are briefly discussed below.

For many leaders of the Chilean left, the experience of exile meant first-hand exposure to European social democracy at work, as well as to the failure of 'real socialism' in the Soviet Union, Eastern Europe and elsewhere. This led to their gradual reappraisal of the role of markets in economic life, and to the emergence of 'renewed', social democrat sectors

within the main left-wing parties (the Socialist Party and the Party for Democracy). These groups have become increasingly influential over time.

The other main partner in the Concertación coalition, the Christian Democratic Party, was historically not as hostile to markets as the left parties. However, its roots are not economically liberal either, as they are heavily influenced by corporatism and the Catholic Church's social doctrine. Its shift towards a more market-friendly approach was spearheaded by CIEPLAN, a mostly economic think tank created in 1976.[19] CIEPLAN grouped a number of Chilean economists, most of them associated with the Christian Democratic Party and with graduate studies in prestigious US universities. Their research provided a critique of the military government's economic policies that was both analytically rigorous and grounded on standard economic theory. CIEPLAN thus greatly influenced the Concertación's government programme in the late 1980s, and after 1990 many of its best known academics have occupied top economic posts in the successive democratic administrations.

Under the Concertación governments, some of the structural reforms initiated by the military regime have been modified, but not repudiated. For example, some changes to labour laws were introduced in 1991, restricting the grounds for firing employees, increasing the compensation that firms had to pay to lay off employees, and restricting employers' recourse to lockouts. While these and other changes marked a break with the authoritarian regime, they did not amount to a major alteration of the labour-market regime.

Trade Policy

Chilean trade policy under the Concertación administrations can be described as following a 'multi-track' or 'lateral' approach (Sáez and Valdés, 1999). The policy of unilateral opening started during the military regime has not only been maintained, but actually deepened. At the same time, the country has been an active player at the multilateral level, both during the Uruguay Round and in the current Doha Round. Finally, a new and growing emphasis on bilateral and regional agreements was added. This 'lateral' strategy is based on the concept of 'open regionalism'. This concept was enshrined – although not defined – as a fundamental principle of the Asia Pacific Economic Cooperation (APEC) since its creation in 1989, and was later popularized in Latin America by ECLAC.[20] According to the Chilean authorities' own vision, open regionalism 'seeks to ensure that no trade agreement limits the freedom [of Chile] to negotiate further agreements or creates more obstacles *vis-à-vis* other trading partners'

(WTO, 1997). Mirroring these changes, the Foreign Ministry – through its specialized Trade Directorate – has assumed a leadership role in trade negotiations.

Although the focus of this book is on autonomous trade liberalization, free trade agreements have become such a prominent feature of Chile's trade policy since 1990 that it is relevant to look at the causes of this trend. Several forces were at play (see Box3.1).

BOX 3.1 THE ROOTS OF CHILEAN TRADE REGIONALISM SINCE 1990

Chile's steady move into bilateral and regional trade agreements since 1990 results from a number of factors. A first precondition was obviously the country's emergence from dictatorial rule. Moreover, by the early 1990s there was a certain consensus among the economists associated with the incoming Concertación coalition that it was time to move beyond an exclusive focus on unilateral opening (Butelmann and Meller, 1993; Agosin, 1993; Velasco and Tokman, 1993; Ffrench-Davis, 1996). The substantial unilateral opening of the 1970s and 1980s had allowed the Chilean economy to reap substantial efficiency gains. However, the open trade regime that Chile already had in the early 1990s meant that the additional efficiency gains from further unilateral opening would be much smaller.

A third element was the desire to promote exports with higher value-addition, reflected in the discussions about a 'second exporting phase'. To achieve this, improved access to foreign markets for more sophisticated products was required. This could not be obtained via unilateral opening. Therefore, a new strategy incorporating some element of reciprocity appeared necessary.

Fourth, the world economy had by the early 1990s moved clearly towards regional agreements, with the Canada–USA Free Trade Agreement (later NAFTA), the Single Market project in the European Union, and the creation of APEC and MERCOSUR. This trend provided an additional, defensive rationale for a small country like Chile to either join or negotiate FTAs with the main blocs. The substantial geographical diversification of Chilean exports made this argument especially compelling.

Fifth, during most of President Aylwin's administration there was uncertainty about the outcome of the Uruguay Round. Therefore, Chile – along with many other countries – took some form of

'insurance policy' in the form of bilateral agreements (Sáez and Valdés, 1999).

Sixth, the Uruguay Round did not achieve as much liberalization as Chile expected in several areas, such as agriculture. Indeed, Chile acknowledges that the liberalization that can be achieved at the multilateral level is necessarily limited. Therefore, the country has negotiated faster and more comprehensive liberalization with countries that were prepared to do so. A clear example is the elimination of antidumping duties in the Chile–Canada and Chile–EFTA FTAs, something that is inconceivable in the WTO. Moreover, multilateral liberalization is not a continuous process. The launch and conclusion of every trade round are difficult processes, highly dependent on the political and economic conditions in the major trading powers. A small country like Chile, highly dependent on exports, cannot simply 'wait until the next round' – or even until a round in progress is completed – while its competitors are negotiating preferential deals in all its most important markets. Furthermore, Chile's experiment with bilateralism has neither stopped unilateral liberalization nor resulted in a lack of attention to the multilateral sphere.

Seventh, Chile's flat and relatively low tariff ensured that bilateral agreements would not create significant trade diversion (Velasco and Tokman, 1993). One of the reasons behind the decision to unilaterally reduce the MFN tariff between 1999 and 2003 was to further reduce the scope for trade diversion caused by free trade agreements.

Finally, the re-democratization process that took place across Latin America in the 1980s and early 1990s, coupled with increased convergence in economic policies along market-based lines, created the conditions for a renewal of the integration drive. Within the region, integration agreements have often had an important political logic. For Chile this is particularly clear about its relations with its neighbours: Argentina, Peru and Bolivia. These have traditionally been characterized by tensions (two wars with both Peru and Bolivia in the nineteenth century, a near-war situation with Argentina as late as 1978). Chile has seen a reinforced institutionalized integration with its neighbours, including trade but going well beyond it, as a means to promote peaceful and cooperative relations.

There has been a substantial degree of continuity between the trade policies of the successive democratic administrations. However, it is possible to distinguish three phases in it, which broadly coincide with the stints of Presidents Aylwin (1990–1994), Frei (1994–2000) and Lagos (2000–2006).

The Aylwin administration (1990–94)

The most important trade measure adopted by President Aylwin's administration was to lower Chile's applied Most Favoured Nation (MFN) tariff from a uniform 15 per cent to a uniform 11 per cent in June 1991. This was intended to ease the tendency towards appreciation of the Chilean peso resulting from increased capital inflows (Jara, 2005). The Government's tariff reduction plan was approved unanimously in Congress.

The newly democratic Chile chose neither to return to the Andean Pact (later renamed Andean Community) nor to join the new Common Market of the South (MERCOSUR), created in 1991.[21] This decision responded to several reasons. First, at the time several members of both blocs were still experiencing important levels of macroeconomic instability. Second, both groups are customs unions with (incomplete) common external tariffs that differ from Chile in that they are not uniform and are on average higher than Chile's. Third, both integration projects aim at common policies or regimes in several areas of economic policy, which are not necessarily compatible with Chile's own policies. Therefore, joining either group would have meant for Chile surrendering its autonomy in trade policy and in other areas of economic policy, as well as in trade negotiations. Instead, Chile obtained 'associated member' status in both groups.

Chile's independent-minded policy has attracted criticism within South America (and occasionally within Chile itself). However, it has proved beneficial, as it has allowed it both to go faster with its own reforms and to exploit opportunities that would not have been available to it as a member of one of the two main integration schemes in the region. Chile's FTAs with the United States, European Union, Korea and China are clear examples.[22]

During the Aylwin administration Chile negotiated its first free trade agreement, with Mexico in 1991. At Chile's request, the agreement provided for the elimination of tariffs on almost all products. Therefore, it represented a significant departure from the traditional approach in Latin America, based on partial product coverage and tariff reduction rather than elimination. However, its scope was limited to trade in goods. The agreement with Mexico was followed in 1993 by two others, along the same lines, with Venezuela and Colomba.

The new democratic administration was very keen to reassure international investors about its intention of keeping unaltered the liberal economic policies implemented by the military government. This was a key factor behind the strong priority Chile gave from the early 1990s to either joining NAFTA or negotiating a bilateral FTA with the United States. Arguably the importance of this motivation fell over time, as successive democratic administrations proved their commitment to a liberal economic model.

The end of the Aylwin administration coincided with the conclusion of the Uruguay Round. Chile committed to reduce its bound MFN tariff from 35 per cent to 25 per cent for practically all products by 2000, in fulfilment of the agreed cuts for developing countries.[23] In addition, Chile made commitments in several service sectors within the context of the General Agreement on Trade in Services (GATS).[24] Those commitments essentially bound the policy framework in place at the time (WTO, 2003).

Summarizing, the main objective of Chilean trade policy during the first post-Pinochet democratic administration was twofold. First, to send a clear message of continuity with the fundamentals of the 'Chilean model' to economic agents both in Chile and abroad. And second, to put the country again on the Latin American map after a long period of diplomatic isolation. The first goal was achieved by locking in – and in the case of tariffs, deepening – the country's openness levels to trade and foreign direct investment. This was done both unilaterally and multilaterally (through Uruguay Round commitments). The second goal, which had at least as much to do with foreign policy as with trade, was pursued through the negotiation of bilateral agreements.

The Frei administration (1994–2000)

During the administration of President Eduardo Frei Ruiz-Tagle, Chile continued to extend its net of bilateral and regional agreements in Latin America, while at the same time it began venturing further afield. In 1994 it joined APEC and was invited to join NAFTA (this offer never materialized, however, due to the Clinton Administration's lack of 'Fast Track' authority). New FTAs were added with Ecuador (1994), MERCOSUR (1996), Canada (1997) and Peru (1998). The FTA with Canada, Chile's first free trade agreement with a developed country, was also the first in which the country undertook commitments in areas such as services and investment. Both parties also agreed not to apply antidumping duties to each other. Chile was also an active participant in the FTAA (Free Trade Agreement of the Americas) negotiations, launched in December 1994.[25]

On the multilateral front, Chile advanced its Uruguay Round bound tariff reduction schedule from 2000 to 1996, as a result of commitments in APEC. It also publicly and continuously supported the launch of a new round of multilateral trade negotiations in the WTO.

Two important events took place in domestic trade policy. First, a law was passed in 1998 providing for a further reduction of five percentage points in Chile's applied Most Favoured Nation (MFN) tariff, from 11 per cent to 6 per cent, to be implemented uniformly in the same number of years. The rationale for this decision was twofold: to improve the overall competitiveness of the economy, and to reduce the room for trade diversion that could arise as the result of the country's various free trade agreements. This tariff reduction plan was more controversial than the one of 1991, as the first effects of the Asian crisis had begun to be felt, as well as increased flows of cheap imported manufactures (Jara, 2005; Silva, 1999). This was compounded by increased agricultural imports from MERCOSUR following the 1996 agreement and which hit Chile's politically influential import-competing agricultural sector.

In this context, to make possible the approval in Congress of the tariff reduction plan, the Government committed to introduce draft legislation allowing the application of safeguard measures. This legislation, which entered into force in May 1999, is stricter than the WTO's Agreement on Safeguards. For example, it only allows for safeguard measures to last one year, renewable for up to one additional year, instead of the 'four plus four' years allowed by the WTO. The effectiveness of the general safeguards regime as a protection tool is further eroded by provisions in several of Chile's free trade agreements that set strict conditions for safeguards to be applied to FTA partners.

The Lagos administration (2000–2006)

During the administration of President Ricardo Lagos, the implementation of the unilateral tariff reduction plan approved in 1998 was concluded. Also during the 2000–2006 period Chile modified several trade-related laws (such as on customs procedures, trade-related investment measures in the automotive sector, and protection of intellectual property rights) pursuant to Uruguay Round commitments. In the multilateral sphere, Chile enthusiastically supported the launch of the WTO's Doha Round in 2001, and has been an active participant in it. However, the most prominent feature of Chilean trade policy during this period was the conclusion of free trade agreements with several of the world's 'mega markets': the European Union (November 2002), Korea (February 2003), the United States (June 2003) and China (November 2005).[26]

An ambitious, trade-related reform was undertaken with the entry into force of the Government Procurement Law in 2003. The law sets out the principles of public procurement for all governmental and other public institutions, including regional governments and municipalities, but excluding public works and state-owned enterprises. Its objectives are to achieve maximum transparency in public procurement, to allow savings for the State and to promote the use of e-commerce. It makes public tendering compulsory for all contracts exceeding US$ 62 000 (as of May 2007). The law does not provide for different treatment of national and foreign goods, services, or suppliers. The law also establishes a tribunal for public procurement, which deals with infringements of procurement procedures, including for public works (WTO, 2003).

In the area of trade facilitation, Chile has been continuously streamlining its import procedures since 1997, *inter alia* through the introduction of an electronic processing and payment system. Imports are usually cleared the same day they arrive at port (WTO, 2003).

IMPACT OF THE REFORMS

Protection Levels

Chile's bound tariff rate since the end of the Uruguay Round is a flat 25 per cent, with a handful of exceptions in agriculture (see note 22). As a result of its last unilateral tariff reduction, Chile's applied MFN tariff has been a flat 6 per cent since 1 January 2003, again with roughly the same exceptions as for the bound rate. Taking into account Free Trade Agreements, the country's average applied tariff level is much lower, at around 2 per cent (and going down). This reflects the fact that the countries with which Chile has subscribed such agreements account for 79.4 per cent of the country's trade (as well as for 76.6 per cent of the world's produce).[27] Chile maintains only one multilateral tariff-rate quota, for sugar, although it has negotiated some others under bilateral agreements, usually for sensitive agricultural products.

Except for a handful of import-competing agricultural commodities (sugar, wheat and wheat flour, dairy and poultry), the tariff level has almost ceased to be a relevant variable. Today productive sectors in Chile (both exporters and those competing with imports) tend to care more about the exchange rate. Trade remedies are also used very scarcely, with the exception of safeguards for the agricultural commodities already mentioned.

Chile follows a general policy of no permanent a priori exceptions in its free trade agreements. Sensitivities are dealt with through longer tariff phase-out periods. The only exceptions respond to reciprocity considerations (that is, when a partner in an FTA permanently excludes items of exporting interest to Chile from tariff elimination). Chile also maintains the policy that its FTAs must have the widest thematic coverage possible, including trade in services, investment, government procurement and other 'second generation' areas. It has accordingly been expanding and updating its network of FTAs within Latin America, which originally covered only trade in goods.

Trade and Investment Performance

Chile's total merchandise trade reached a record US$ 95 billion in 2006, explained by exports of US$ 59 billion and imports of US$ 36 billion. Its ratio of merchandise trade to GDP was 63.4 per cent in 2005, and 76.4 per cent if trade in services is included (World Bank, 2007). Chile's trade is geographically well diversified. In the case of exports, in 2006 Asia absorbed 34 per cent, the European Union (EU-25) 27 per cent, the NAFTA countries 22 per cent, and Latin America 13 per cent. In the case of imports, 34 per cent came from Latin America, 20 per cent from both Asia and the NAFTA countries, and 15 per cent from the EU-25.

While in 1975 Chile exported 200 products by 200 companies to 50 destinations, in 2004 it exported 5238 products by 6636 companies to 171 destinations.[28] Despite this successful diversification effort, Chile remains highly dependent on copper exports. Copper's share in total exports, after being brought down to around 40 per cent in the 1990s, has rebounded strongly in the last years, reaching nearly 55 per cent in 2006. This reflects the currently very high international price, caused among other factors by soaring demand in China.

Foreign direct investment has also played a crucial role in fostering Chile's integration with the world economy. The Chilean FDI regime accords National Treatment to foreign investors with only a few sectoral exceptions (international land transport, maritime cabotage, fisheries, and radio and print media).

Chile's FDI stock reached 64.6 per cent of GDP in 2005, up from just 30 per cent in 1990. By comparison, in 2005, the average world figure was 22.7 per cent, and 27 per cent for developing countries (UNCTAD, 2006). For the past ten years, the ratio of FDI to GDP has averaged 6–8 per cent, higher than the OECD average and any other Latin American country.

Between 1974 and 2006, materialized FDI in Chile totalled US$ 84.1 billion. It is worth noting that 90 per cent of this amount entered the country after 1990. This suggests that foreign investors have rewarded the increased political, social and macroeconomic stability that has characterized the country since regaining democracy. In recent years, foreign investment has increasingly been taking place not just to supply the Chilean market but also other markets, especially within Latin America, taking advantage of Chile's network of free trade agreements.[29] In this context, a large number of multinational companies currently have operations in Chile.[30]

In terms of composition, between 1974 and 2005, the mining sector was the main receptor of FDI, accounting for 33.1 per cent of gross inflows under the Foreign Investment Statute. It was followed by services (19.6 per cent), utilities (19.2 per cent), manufacturing (12.7 per cent) and transport

and communications (11.6 per cent). Since 1990 the share of mining in total FDI has decreased (it represented 47 per cent until that year) and other sectors have expanded, notably transport and communications and utilities. This was mainly the result of privatizations in the energy and telecommunications sectors and of increased competition following the deregulation of mobile and long-distance telephone services. An infrastructure concessions programme, launched in 1995, opened the way for the participation of private capital, mostly from abroad, in the construction and operation of roads and airports. Water privatizations and a concessions programme for water treatment services have also attracted important FDI inflows in recent years.[31]

Chile has also become an active foreign investor, especially within South America. It is estimated that between 1990 and 2006 Chilean investment abroad exceeded US$ 38 billion, with Argentina, Brazil, Peru and Colombia accounting for 80 per cent of the total. However, there are registered Chilean investments in countries as far as Spain, Australia, Croatia or the United Arab Emirates. Most Chilean FDI concentrates on energy, forestry, manufacturing and a wide variety of services (especially financial and retail services, but also other emerging sectors such as engineering, information technology and even air transport).[32]

The Services Sector[33]

Services are the most important sector of the Chilean economy in terms of contribution to GDP and employment (52.7 per cent and 62.8 per cent respectively in 2002). Conditions for foreign participation in Chile's services sector are far more liberal than implied by its GATS commitments. Foreign participation in Chile's services sector is substantial, especially in financial services and telecommunications. Since the early 1990s, Chile's telecommunications sector has been fully privatized. There is substantial presence of foreign companies in the sector.

State involvement in the provision of commercial services is limited. The State retains ownership of one bank (BancoEstado), the postal and railway services, and one public television channel. It also owns major seaports and airports; however, these have been increasingly given in concession to private operators. State involvement in any of these sectors does not preclude private participation.

Equity caps only exist in the maritime transport sector, where more than 50 per cent of the capital of a shipping company must be owned by Chileans. Maritime cabotage is also reserved by law for Chilean enterprises. There are also limits on the proportion of foreigners allowed to work in a company established in Chile: according to the Chilean labour code, foreign natural persons cannot make up more than 15 per cent of the total staff employed in Chile. This provision does not apply to highly specialized personnel with skills that cannot be procured in Chile.

Chile's banking system includes a large number of foreign-owned or controlled banks. Foreign banks incorporated in Chile and branch offices are allowed to undertake the same range of activities as national banks and are subject to the same regulations. Foreign financial services providers that wish to establish a commercial presence in Chile must obtain authorization from the Superintendent of Banks and Financial Institutions (in the case of banking services) and from the Superintendent of Securities and Insurance (in the case of insurance services). Authorization depends on market conditions.

Chile's air transport policy is based on the principles of open skies, free competition between airlines, and freedom of price-setting. Chilean and foreign airline companies are allowed to supply commercial air transport services both domestically and internationally. However, by law the participation of foreign companies is allowed only on the basis of reciprocity. Chile's airports are state-owned, but their construction and administration, including the provision of terrestrial auxiliary services, has been given in concession to private enterprises. With the exception of traffic control, the State is not involved in the provision of air transport or auxiliary services.

Macroeconomic and Growth Performance

Chile shows a strong growth record in the last 20 years. Even accounting for the 1998–2003 slowdown, its GDP grew at an average of 5.8 per cent between 1987 and 2006, the fastest rate in Latin America. Agosin (1999) argues that Chile since the mid-1980s is a case of export-led growth rather than one of 'growth-induced exports'. He identifies export expansion and growth in investment as the Chilean economy's twin engines of growth in this period.[34] Since 1990, investment has represented between 22 and 27 per cent of GDP, well above the levels it reached during the period of military rule (Ffrench-Davis, 2003). This has allowed higher and more sustained growth.

In spite of being a very open economy, Chile is today less vulnerable to external shocks than it historically was. This is explained in large part by its solid macroeconomic policies since 1990. Inflation, still at 26 per cent in 1990, was brought down to single-digit levels by 1995. The Central Bank, made autonomous towards the end of the military regime in 1989, adopted in 2000 an inflation-targeting policy, with a target band of 2 to 4 per cent. Inflation levels have been within this band in all years since 1999. In other words, Chile presents since the late 1990s inflation levels comparable to those in OECD countries.[35] The consolidated net public debt (central government and Central Bank) represented less than 6 per cent of GDP in 2004, down from nearly 34 per cent of GDP in 1990 (OECD, 2005).

In 1999 the Central Bank abandoned the policy of targeting the nominal exchange rate that had been pursued since 1984 and let the peso float freely. In so doing, it has allowed the exchange rate to play a greater role in the stabilization of activity in response to external shocks.

Fiscal policy has assumed a counter-cyclical stance since the introduction in 2001 of the structural surplus rule. This rule stipulates that the calculation of the annual budget should produce a surplus of 1 per cent of GDP, assuming a level of activity consistent with the economy's trend output growth. In so doing it allows an expansionary fiscal policy in periods of low economic activity, without interfering with the country's monetary policy or raising the risk perception of foreign investors.[36] The responsibility for estimating the values of the two key variables in this calculation – the economy's trend output growth and the medium term copper price – has been delegated to expert panels, therefore reducing the risk of political interference (OECD, 2005).

During most of the 1990s Chile maintained some capital controls. These were a response to the great abundance of foreign capital the country experienced during most of that decade, and to the desire to prevent such inflows from inducing an excessive appreciation of the peso. The authorities therefore put in place measures to discourage inflows of short-term capital,[37] while continuing to welcome FDI (Agosin, 1999). The development of hedging instruments together with the increased maturity of the Chilean financial system and the credibility of its macroeconomic policies made it possible to eliminate these restrictions in 2001 (WTO, 2003).

While in the past copper prices had a big effect on the country's macroeconomic stability, this effect has been moderated since the creation of the Copper Stabilization Fund. This fund was set up in 1986 in the context of a structural adjustment programme with the World Bank. It allows the Chilean State (the only shareholder of CODELCO, the world's largest copper producer) to maintain a stable spending pattern in spite of fluctuations in copper's international price. It does so by providing for the collection of surpluses in times of high prices and their withdrawal when prices are lower.

Employment

Unemployment was at double-digits during practically the whole period of military rule. Although there are no comparable figures available for the national unemployment rate before 1986, the series compiled by the University of Chile on unemployment in Greater Santiago since 1960 provides a good proxy.[38] It shows that unemployment reached particularly high levels following the recession of 1975 (over 16 per cent in that year and 1976) and especially the one of 1982 (exceeding 22 per cent in that year and 1983). Moreover, the figures for the 1980s substantially underestimate the extent of the problem, as they exclude the emergency employment programmes put in place after 1982 and that essentially amounted to masked unemployment.

The national unemployment series available since 1986 shows a brighter picture. Starting at 12.1 per cent in that year, the unemployment rate finally reached a single-digit level in 1988 (9.7 per cent) as a result of economic recovery in the second half of the 1980s. It continued to decrease gradually in a context of high and sustained growth, reaching its lowest level (an average of 6.3 per cent) in the 1996 to 1998 period. It rebounded again in 1999, the only year since 1983 in which the Chilean economy has experienced negative growth (-0.7 per cent). This took place in the wake of the Asian and Russian crises and in a context of high interest rates that choked economic activity. Unemployment remained at 9 to 10 per cent levels until 2005, finally beginning to ease off towards the end of that year. The average for the first half of 2007 was 6.8 per cent, suggesting that the economy is finally close to the levels of the mid-1990s.

Poverty Reduction

Since regaining democracy, Chile has experienced a massive reduction in poverty, from 38.6 per cent of the population in 1990 to 13.7 per cent in 2006 (14 per cent in urban areas and 12.3 per cent in rural areas). Extreme poverty (that is, destitution) has been reduced from 13 per cent in 1990 to 3.2 per cent in 2006.[39] This record is unparalleled in Latin America. Poverty reduction has been matched by improvements in social indicators, including enrolment in primary education, youth literacy, infant mortality and life expectancy, with these indicators reaching levels close to those in advanced economies. According to the OECD, infant mortality, which stood at 78 children per 1000 live births in 1970, had fallen to 17 children by 1990 and 7.6 by 2004. Life expectancy at birth has also risen steadily and in 2004 stood at 78 years.

It is widely recognized that strong and sustained economic growth, complemented by much increased social spending in areas such as health and education, has played a key role in the above achievements. It is also broadly accepted that the openness of the Chilean economy has contributed strongly to the country's robust economic performance. It can

therefore be argued that this openness has also helped to reduce poverty and to otherwise improve social indicators.

CHALLENGES AHEAD

> As in previous years, **Chile,** ranked 27th, leads the rankings in Latin America and the Caribbean. Chile's position reflects not only solid institutions – already operating at levels of transparency and openness above those of the EU on average – but also the presence of efficient markets that are relatively free of distortions. The state has played a supportive role in the creation of a credible, stable regulatory regime. Extremely competent macroeconomic management has been a critical element in creating the conditions for rapid growth and sustained efforts to reduce poverty. The resources generated by Chile's virtuous fiscal policy have gone to finance investment in infrastructure and, increasingly, education and public health. Given Chile's strong competitive position, the authorities will have to focus attention on upgrading the capacity of the labour force with a view to rapidly narrowing the skills gap with respect to Finland, Ireland and New Zealand, the relevant comparator group for Chile. (The Global Competitiveness Report 2006–2007, World Economic Forum)

Chile is now an upper-middle income country. Its per-capita gross national income, of US$5870 in 2005 (US$11470 in purchasing power parity terms), exceeds those of all Latin American countries except Argentina, is similar to the levels in Russia and South Africa, but lower than in all OECD countries except Mexico and Turkey. Notwithstanding two decades of rapid growth, per capita incomes are still less than half the OECD average.[40]

Today Chile shows much improved social indicators and a solid record of macroeconomic stability, with low inflation, a structural fiscal surplus and a strong reserve position. It has the lowest country risk in its region, and along with Mexico, is the only sovereign borrower in Latin America to enjoy an investment-grade credit rating.

Chile is widely considered the freest economy in Latin America and the Caribbean.[41] Moreover, it is widely considered to have transparent institutions and a generally effective regulatory framework.[42]

Arguably Chile's main challenge over the coming decade will be to cross the development threshold, catching up with the lower-rung members of the OECD. This will imply, as the OECD itself has put it, 'lifting the economy's growth potential' (OECD, 2005).[43]

Chile is a clear example that natural resources are not necessarily a curse. However, doubts remain as to whether 'more of the same' will be enough to cross the development threshold, and if so, when. In particular, it has been pointed out that there are countries with natural resource endowments similar to Chile's, but with a more abundant and cheaper workforce, and closer to the world's big 'centres of consumption'. The vulnerability of comparative advantages based on exhaustible natural resources has also been highlighted, as well as the catching-up effect as other developing countries undertake the same reforms in which Chile was a pioneer (Eyzaguirre et al., 2005). Chile also has a low research and development intensity by international standards (0.7 per cent of GDP, about one-third of the OECD average). And despite the significant progress made since 1990, especially in terms of coverage, Chile's educational performance remains poor in comparison with OECD countries (OECD, 2005).

Against this background, it has been argued that Chile must embrace 'the knowledge economy' more aggressively, while maintaining its specialization in the natural resource areas where it has comparative advantage. The preconditions for this qualitative jump are already in place: the rule of law, macroeconomic and institutional stability, a market-based economy (including liberal trade and investment regimes), reasonably good public infrastructure, a well-regulated and expanding capital market, and notable improvements in educational coverage (Eyzaguirre et al., 2005; OECD, 2005).

A prerequisite to benefit fully from the knowledge economy is to develop the country's human capital. In policy terms, this requires improving the quality of education (especially in the public system, which caters for the majority of the population) and fostering innovation (Eyzaguirre et al., 2005; OECD, 2005). In the microeconomic area, it will be important to improve access to capital for small and medium enterprises and start-ups, as well as finding ways of increasing the very low participation rate of women in the labour force (for example, through the expanded availability of childcare and pre-school education).[44] Other challenges ahead are improving environmental standards, so that Chilean products are not discriminated against by governments or customers in developed country markets, and securing stable and diversified energy sources.[45]

Despite Chile's success with poverty reduction, its income distribution has shown little improvement from the maximum levels it reached towards the end of the military rule period. Today it remains very unequal even by world standards. This issue has become increasingly prominent in the public debate, as the latter gradually shifts from how to eradicate extreme poverty to how to ensure a fair distribution of the fruits of economic growth. Therefore, another major challenge for the political sustainability of the 'Chilean model' is bringing these persistently high levels of income inequality closer to OECD levels.[46]

In the context described above, the role of trade policy in the coming years is less obvious than it was in the last three decades. With an average applied tariff level around 2 per cent (and going down), few gains can be expected from new unilateral tariff reductions, except to simplify customs procedures. The Chilean services regime is also recognized as generally very open. On the other hand, Chilean exporters enjoy today free, or at least preferential, access to the world's biggest and most dynamic economies. The main challenge in the area of trade policy is now to exploit these opportunities fully. This will require a big public effort to disseminate information on the markets concerned and on the opportunities opened through the FTAs.

Summing up, Chile's economic references in the coming years will be those developed countries that have been able to prosper by adding value to mostly natural resource-intensive exports (Australia, Canada, New Zealand) and those that, being relatively small economies, have succeeded by adopting the right policies in areas such as education, innovation and fostering entrepreneurship (Ireland, Scandinavia).

CONCLUSION

For an outside observer, if there is one common thread in Chile's trade policy over the last three decades, it is a consistent commitment to trade liberalization. Aside from a brief policy reversal right after the economy's near-collapse in the early 1980s, both the right-wing Pinochet dictatorship and the successive centre-left administrations led by the Concertación have pursued freer trade almost relentlessly. All avenues have been explored: unilateral liberalization (in the second half of the 1970s, in the second half of the 1980s, in the early 1990s and again in the late 1990s), multilateral commitments in the GATT/WTO, and most visibly now, free trade agreements since the early 1990s. Chile has experimented both with 'big bang' reforms under dictatorial rule and gradualist reforms in democracy (see Table A3.1 in the Appendix for a chronology of Chile's trade and investment reforms).

How did this come to pass? It certainly was not a foregone conclusion in September 1973. There was no reason to expect that the military, once in power, would preside over a period of such radical economic reform. Many other military dictatorships in Latin America and elsewhere chose to leave the import-substitution model essentially in place.

In the Chilean case, it was a very specific set of circumstances that allowed events to happen the way they did. The seriousness of the country's crisis in 1973 provided the conditions for radical reform. But equally crucial was the symbiosis that took place between the military's 'national re-foundation' project and the ideological vision of the Chicago Boys. The military gave the Chicago Boys a free hand to implement their preferred policies. Equally importantly, they carried on with the reforms in spite of the high social cost, buying time for them to finally begin to pay off from the mid-1980s. In a 'normal politics' situation, it is very likely that the social and economic cost of the reforms (including trade liberalization) would have been considered excessive, and the reforms abandoned or at least partially reversed. The result was that, by the time the country regained democracy, the open economy model had been showing positive results for half a decade, both in terms of growth and employment. Moreover, an influential pro-market, pro-free trade constituency had emerged among entrepreneurs. Finally, the leaders of the incoming coalition had just witnessed the collapse of 'real Socialism' in the Soviet Union and elsewhere. In short, there was no turning back the clock.

The military government was responsible for implanting the market economy model in Chile, and for convincing entrepreneurs of its virtues. However, it failed in one crucial aspect: gaining popular support for the model.[47] This task was left for the future democratic administrations. The process was remarkably quick. As one author sympathetic to the military government observed in the early 1990s, the free market model only began to be accepted by the Chilean population at large under democratic conditions (Fontaine, 1993). Writing only two years later, Valdés asserted that export orientation and the opening-up of the economy to foreign competition had 'become articles of faith for Chilean society in general' (Valdés, 1995).

Chile experienced an average growth rate of 6.4 per cent during the first three years of President Aylwin's administration, coupled with falling inflation, rising investment and a fall in unemployment. This good performance in the critical first years of democracy probably explains in good part why the market economy model quickly began to legitimize itself among the wider population. Another, very important part of the explanation lies with the more 'social democratic' nature of the new social compact. After 1990, long-repressed social demands were met through policies such as the introduction of a minimum wage and of an unemployment benefit scheme, as well as through increased social spending in the areas of public health and education, long neglected by the military. In this way, a basic social protection net was created (in some cases, reconstructed). Finally, the search for consensus further reinforced the legitimacy of economic policies among the wider population. In sum, democracy allowed 'a social pact between government, business sectors, and workers' (Valdés, 1995).

Against the predictions of many supporters of the military government (including some prominent Chicago Boys), democracy has not only proved not to be a problem for the working of the open economy model: it has actually reinforced it. The overall performance of the Chilean economy improved dramatically since 1990, in a context of political and social

stability, coupled with greater policy coherence, better macroeconomic management and a strengthened regulatory framework. This has of course been greatly facilitated by the near consensus that exists across the Chilean political spectrum on the fundamentals of a market-based, outward-oriented economy.

A number of lessons can be distilled from the rich experience Chile has accumulated in over thirty years of trade-related reforms. While some of them are more specific to the Chilean context than others, all of them have some level of applicability to other developing-country situations. Following are some of the most important.

When launching a trade reform, it is important to eliminate quantitative restrictions first, as Chile did in the first stage of its reform between 1974 and 1975. This is so because quantitative restrictions are the most distorting kind of trade barriers, as they inhibit response to price signals – and therefore the reallocation of resources – more than tariffs. Anyway, this particular recommendation has lost most of its relevance, as the vast majority of developing countries have by now committed under WTO rules not to maintain quantitative restrictions.

The near-collapse of the Chilean economy in 1982 illustrates the importance of policy coherence during reform. Specifically, governments should try to avoid real exchange rate appreciation while simultaneously reducing tariff protection, so as to avoid a 'double whammy' effect on import-competing sectors. The 1982 crisis also points at the importance of proceeding cautiously when opening the capital account, and of putting in place a sound regulatory framework for the financial sector before doing so.

The Chilean experience also shows the importance of macroeconomic stability, including low inflation, to allow economic agents to assess adequately where to channel resources in response to price – including trade – liberalization. High inflation and macroeconomic stability in the first years of reforms made it difficult for economic operators to assess the comparative competitiveness of different industrial sectors. Investment in Chile's sectors of comparative advantage picked up significantly in the second half of the 1980s, and especially from 1990 onward, in the context of increased macroeconomic stability and lower inflation.

The Chilean experience suggests that a gradual approach to trade reform is in principle preferable to a 'big bang' one, as it allows a more orderly adjustment by the productive agents, thereby minimizing economic and social costs. As it has been shown, the second trade reform under military rule delivered better results than the first, in spite of being less ambitious. However, an assessment of the relative merits of each approach will necessarily depend on the circumstances. For example, Chile arguably needed some sort of 'big bang' to kick-start reforms in the highly distorted economic environment prevailing after the military coup. In contrast, all subsequent trade reforms took place in a much less distorted environment, therefore allowing for more gradualism and fine tuning. Moreover, a large part of the explanation regarding why the first trade reform ended in collapse had to do with inadequate policies in other areas and a general lack of policy coherence, rather than with the depth or speed of trade reform per se.

Chile's experience with an essentially flat tariff structure has been largely positive. While being an extreme case, the Chilean experience points at the benefits of a simple tariff structure that avoids large tariff dispersion. These benefits accrue through a less distorted allocation of economic resources, more transparency and predictability for economic operators, fewer incentives for lobbying, and a simplified customs administration. Moreover, the low and uniform tariff has allowed Chile to negotiate bilaterally with different partners, by reducing substantially the scope for both trade diversion and incoherence among the different agreements.

Chile's successful second trade reform highlights the benefits of pragmatism, as shown in the use of different types of export incentives (including some export subsidies). It is worth recalling, however, that some of those export incentives are no longer legal under WTO rules. Increasingly intrusive multilateral rules mean that developing countries have less 'policy space' now than in the 1980s.

In this new international context of reduced policy space, the role the State can play in fostering exports through WTO-consistent, horizontal mechanisms becomes even more important. In particular, the experience of ProChile highlights the benefits of an active export-promotion agency in gathering and disseminating information on foreign markets and in encouraging small and medium enterprises to associate and cooperate to explore those markets.

The most important lesson that can be drawn from the Chilean experience is one that has already been mentioned: democracy is in no way intrinsically detrimental to trade reform or to economic growth in developing countries. Ultimately, trade reforms – indeed, any reforms – need political legitimacy if they are to be preserved in the long run. The specific type of export model Chile developed under the military, based on low wages and an aggressive exploitation of the country's natural resources, could not be sustained indefinitely. For their part, the continued large inflows of foreign investment since 1990 strongly suggest that investors put a premium on stability, not just economic but also political and social. At the same time, it cannot be ignored that trade policy-making under democratic politics has been greatly facilitated in Chile by the country's near consensus on the benefits of free trade.

NOTES

1. The views expressed in this article are those of the author and do not necessarily reflect those of the Chilean government.
2. Compared with the average of the 1927–29 period, in 1932 Chile's gross domestic product (GDP) had fallen by 38.3 per cent, its exports by 78.3 per cent, its imports by 83.5 per cent, and its per-capita GDP by 42 per cent (Meller, 1996).
3. Populist (Ibáñez, 1952–58), Conservative (Alessandri, 1958–64), Christian Democrat (Frei, 1964–70). Several, largely unsuccessful, attempts to reform the trade regime were made in 1956, 1959–61 and 1968–70 (De la Cuadra and Hachette, 1988).
4. Until the early 1950s, the electorate accounted for only 10 per cent of the population. Women were allowed to vote in 1950 and the illiterate population only in 1970. As a result of these and other electoral reforms, the electorate grew from 1.28 million in 1957 to 3.24 million in 1969 (Fontaine, 1993).
5. Between 1950 and 1970, Chile's per capita GDP grew at a yearly average of 1.4 per cent, compared with an average of 3.1 per cent 6 per cent for the group of developing countries with a comparable income level, and with 3.3 per cent for the industrialized countries (Fontaine, 1993).
6. An excellent reference on the Chicago Boys is Valdés (1995).
7. The Andean Pact (now Andean Community), created in 1969, is an integration scheme comprising trade and other policies. Its other members at the time Chile abandoned it were Peru, Bolivia, Colombia, Ecuador and Venezuela.
8. Although the importance of a tariff structure with low dispersion is widely accepted among Chilean economists, the flat tariff policy has attracted some criticism. One example is Ffrench-Davis (2003).
9. This may have had to do with the high tariff level at the beginning of the reform, which meant that the early reductions were only eliminating redundant protection (Meller, 1994; Ffrench-Davis, 2003).
10. Chile's Foreign Investment Committee argues that in practice the one-year capital lock-in has not represented a restraint since most productive projects – in areas such as mining, forestry, fishing and infrastructure – require more than a one-year start-up period (see www.cinver.cl).
11. Jara (2005) presents evidence in the sense that, had it not been for the Tokyo Round binding, tariffs would have been increased beyond 35 per cent.
12. Between 1982 and 1987, Chile's external debt was bigger than its gross domestic product and four times higher than its exports (Meller, 1996).
13. The Chilean peso depreciated 130 per cent in real terms between 1982 and 1988 (Ffrench-Davis, 2003).
14. Purchasers of Chilean-made capital goods were entitled to a tax credit equivalent to 73 per cent of the customs duty on the net invoice value of the goods.
15. There were some exceptions. For example, during the 1980s Chile achieved one of the lowest infant mortality rates in Latin America (0.84 per cent). This probably responded to some extent to the efforts made by the military regime to target some social programmes at the most vulnerable groups (Meller, 1996).
16. There are no comparable figures on income inequality at the national level before 1987. However, there are older series based on occupation polls conducted by the University of Chile in the Greater Santiago area. These show that the Gini coefficient, which measures income inequality, climbed from a value of 0.476 in the 1958–63 period to a maximum of 0.570 in 1987–90.
17. The Constitution that entered into force in 1980 envisaged a referendum in 1988 on the continuity of the military regime for a further eight years. Following the victory of the 'No' option with nearly 55 per cent of the votes, presidential elections took place in December 1989. These were won by the Concertación's candidate, Patricio Aylwin of the Christian Democratic Party, over the right-wing candidate Hernán Büchi (who had served as Finance Minister between 1985 and 1989).

18. Arguably the main strength of the Concertación has been its broad character. It includes forces such as Socialists, Social Democrats and Christian Democrats that, while all in opposition to the Pinochet regime, were in opposite camps during the Allende period. This inclusiveness has provided successive administrations with a broad base of popular support and legitimacy.
19. See www.cieplan.cl.
20. See ECLAC (1994).
21. MERCOSUR's current members are Argentina, Brazil, Paraguay and Uruguay. Venezuela, which withdrew from the Andean Community in 2006, is in negotiations to become a full MERCOSUR member.
22. The argument can be summed up as 'the advantage of being single (and small)'. Chile is an economy small enough not to threaten the viability of any productive sectors in its FTA partners (even in agriculture). This is obviously not the case for MERCOSUR, for example, which contains agricultural powerhouses such as Brazil and Argentina.
23. Wheat, wheat flour, sugar, vegetable oils and dairy products were bound at 31.5 per cent. The sugar bound tariff was raised in 2001 to 98 per cent. This product is subject to the price band system, created in the 1980s. The price band provides for a higher tariff the lower the international price. In 1999–2000, very low international sugar prices resulted in Chile's tariffs for that product largely exceeding the bound level, which led to the decision to re-negotiate that level upwards in the WTO.
24. The sectors are business services, leasing and rental services, telecommunications, financial services, tourism and travel-related services, and auxiliary air transport services.
25. These talks did not result in convergence, however, and were frozen indefinitely in 2005.
26. A 'partial scope' agreement was subscribed with India in March 2006, providing for tariff preferences on a number of products. Under the current administration of President Michelle Bachelet, an FTA with Japan was signed in March 2007 and entered into force in September of this year.
27. See the website of the Ministry of Foreign Affairs' Economic Directorate, at www.direcon.cl.
28. ProChile (Chile's export promotion agency). See its English language website at http://www.chileinfo.com/index.php?accion=info_comercial
29. Chile's Foreign Investment Committee. See www.cinver.cl (available in English).
30. For a list, see the English language website of Chile's Foreign Investment Committee, at http://www.cinver.cl/index/plantilla2.asp?id_seccion=1&id_subsecciones=100.
31. Chile's Foreign Investment Committee. See www.cinver.cl (available in English).
32. Ministry of Foreign Affairs' Economic Directorate. See http://www.direcon.cl
33. This section is based on WTO (2003).
34. Agosin identifies two main channels through which exports induce growth in a small and developing economy such as Chile's. First, they potentially represent – unlike the domestic market – a nearly infinite source of demand. Second, they promote technological change by financing imports of capital goods, which tend not to be produced domestically.
35. The expected inflation rate for 2007 is around 7 per cent, as a result – among other factors – of increased energy and food costs.
36. Ministry of Finance's website, at www.minhda.cl.
37. FDI was required to remain in Chile for at least one year and a non-interest-bearing reserve on short-term external credit was imposed.
38. It is worth noting, however, that the unemployment rate in the Greater Santiago area tends to be above the national figure in 'bad years' and below it in years of high economic activity. This is probably because Santiago concentrates a disproportionate share of Chile's industry and other activities, such as construction, that are very sensitive to the economic cycle.
39. The poverty line used in Chile corresponds to twice the cost of a basic food basket. In 2006, it was equivalent to about US$90 per person per month in urban areas (US$60 in rural areas). Destitution is defined as income below the cost of one basic food basket. For more details on the methodology used and the evolution of poverty since 1990, consult the Planning Ministry's website: http://www.mideplan.cl/final/categoria.php?secid=25&catid=124.

40. World Bank (2007).
41. Chile is ranked 11th among 162 countries according to the 2007 Index of Economic Freedom, published jointly by the US-based Heritage Foundation and *The Wall Street Journal*. As on previous occasions, it ranked first in Latin America and the Caribbean. See http://www.heritage.org/index/countries.cfm.
42. In 2006 Chile was ranked best in its region in Transparency International's Corruption Perceptions Index (and twentieth overall). See http://www.transparency.org/policy_research/surveys_indices.
43. Last May, the OECD formally invited Chile to start negotiations conducive to full membership.
44. At 40.9 per cent in 2005, Chile's labour force participation rate for women is well below the world's average (57.9 per cent), and is lower than that of any region except for the Middle East, North Africa and South Asia (World Bank, 2007). This very low figure probably responds to a host of reasons, including not just inadequate coverage of childcare and pre-school education, but also entrenched cultural patterns. Chile is widely seen as Latin America's most socially conservative country.
45. Chile is highly dependent on foreign energy sources (oil and natural gas). In recent years it has experienced growing difficulties to secure an adequate and stable supply, especially from neighbouring countries. This in turn puts a question mark on the Chilean economy's growth prospects.
46. Although high even by Latin American standards, Chile's income inequality levels are reduced significantly when State transfers to the poorest segments of society are considered. In 2006, the income ratio between the richest 10 per cent of the population and the poorest 10 per cent fell from 31.3 times to 12.1 times when such transfers were considered (Ministry of Planning, www.mideplan.cl).
47. Fontaine (1993) provides data supporting this view, based on polls conducted in 1988 in Chile's capital Santiago. Just as an example, according to those polls, 54.8 per cent of Santiago's population favoured income redistribution policies as the best means to eradicate poverty, against only 37.6 per cent who preferred economic growth.

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APPENDIX

Table A3.1 Chronology of Chile's trade and investment reforms, 1974–2003

Year/period	Event
1974	The Foreign Investment Statute enters into force: liberalization of the FDI regime
1974–75	First stage of the first trade reform: quantitative restrictions are eliminated, the different exchange rates are unified, tariffs are reduced from an average of 105% to an average of 57%
1975–77	Second stage of the first trade reform: tariffs are reduced to a range from 10% to 35%
1976–81	Elimination of capital controls
1977–79	Third stage of the first trade reform: tariffs are reduced to a flat 10% (except for automobiles)
1979	Tokyo Round: Chile binds all its tariffs at 35%
1982	Debt crisis and near-collapse of the economy
1983–84	Partial reversal of trade reforms: tariffs are raised to 20% (March 1983) and then to 35% (September 1984)
1985–88	Second trade reform: tariffs are reduced to 30% (March 1985), then to 20% (June 1985) and finally to 15% (January 1988)
1991	Unilateral tariff reduction, from 15% to 11%
1991	Capital controls are introduced (on short term capitals)
1991 to the present	Negotiation of several free trade agreements
1994	Uruguay Round: Chile binds practically all its tariffs at 25%[1] and undertakes some commitments on Services
1999–2003	Unilateral tariff reduction, from 11% to 6%
2001	Capital controls are eliminated

Note: 1. Wheat, wheat flour, sugar, vegetable oils and dairy products were bound at 31.5%. The sugar bound tariff was raised in 2001 to 98%.

4. New Zealand

Ron Sandrey

INTRODUCTION

The economic reforms in New Zealand from 1984 onwards rapidly became a benchmark for similar reforms in other countries to be judged against. However, coming from a small and somewhat isolated part of the world one must place these in perspective and recognize that many other countries, such as those of the former Soviet Union and China at one extreme, and economies such as those in this book, have also undergone reforms. However, what sets the New Zealand reforms apart from others was the comprehensive nature and speed of the reforms. While this chapter examines the trade policy reforms, these cannot be viewed in isolation from the overall package, a package that covered the full stabilization and liberalization spectrum of reforms in:

- financial markets
- trade policy
- agricultural and industry support
- research and development
- the labour market
- taxation and taxation policies
- monetary policies
- fiscal policies
- the welfare state itself
- corporatization and eventually privatization
- government departments

Many of these policies are inexorably linked (you cannot have a trade policy without an agricultural policy, for example), and even after a period of nearly a quarter of a century it is hard to clinically assess the overall effects of the package, let alone the effects of an individual component of the package. Arguments continue over the sequencing versus comprehensiveness of the reforms and their associated human cost, but the New Zealand of today is a much different place from that of the early 1980s.