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WHY CHILE MERITS A WORLD BANK LOAN

INTRODUCTION

Bowing to congressional pressure, the State Department has declared it will oppose a $250 million World Bank structural adjustment loan (SAL) to Chile unless the government of General Augusto Pinochet improves its human rights record. The Bank's Board of Executive Directors meets to vote on the loan November 20. The tough U.S. position has found little support from other countries and has been criticized publicly by many Latin American economists.

The U.S. can and should seek to encourage Chile's government actively to restore democracy, but it should not take action that could be counterproductive to that goal. Cutting off World Bank funds for Chile at this time would appear very shortsighted. For all its problems and for all the justifiable criticism of the Pinochet regime, the fact is that Chile is moving steadily if slowly toward democractic government and the improvements in human rights conditions that are sure to follow.

As important, the Chilean government's economic policies have made it a model for the Baker Plan, the strategy named after U.S. Treasury Secretary James Baker for promoting growth through free market and private sector development among debtor countries. Chile has reduced trade and investment barriers, privatized such major public enterprises as banks and the social security system, lowered taxes, eliminated subsidies, and maintained a realistic exchange rate. The result: a 5.8 percent annual growth rate by mid-1986, lower inflation and unemployment, a favorable investment climate, and a greater capacity for paying its debts without undermining its economic growth. The use of economic sanctions to achieve human rights improvements and progress toward democracy, after Chile has adopted the structural adjustments needed to promote real and potentially long-term growth at the same time it is paying its $19 billion foreign debt on time, will send the wrong signal to less compliant debtors, who are resisting U.S. and World Bank urging to adopt structural remedies.

By voting against the loan, the U.S. could weaken its influence over key sectors and players in Chilean society, such as the moderate opposition parties and business associations, which support their government's economic program and understand Chile's need for external financial assistance to foster economic growth. Moreover, sanctions against the Chilean government will affect all Chileans, especially the poor, who benefit from significant public budget allocations for social programs and the jobs created by steady economic recovery.

Most important, the military and especially Pinochet's most loyal supporters, the Army, are likely to react against such direct and punitive pressure. Delicate links with the military, many of whom would likely reject Pinochet's attempt to remain in power beyond the 1989 plebiscite, have been seriously jeopardized by the U.S. position on the loan.[1] The military may well close ranks, cease its tenuous dialogue with the political opposition, and obstruct progress toward a democratic transition. Ultimately, it will be the military that decides the future of Chile, since without its support, Pinochet could not remain in power.

Without the World Bank loan, Chile's agreements with the International Monetary Fund (IMF) and the commercial banks will collapse. In that event, the military government might feel compelled to intervene in the economy to support its debt service requirements. Pinochet would be more powerful than ever and less easily induced to relinquish power to an opposition he might believe had provoked the U.S. sanction.

Instead of using the threat of blocking the World Bank loan to Chile, the U.S. should continue to concentrate on fostering ties with opposition groups and with the military and providing assistance when requested. But the U.S. also should support Chile's economic progress, which more than anything else will strengthen politically stable alternatives. Property owners with a stake in a prosperous society tend to be moderate in their political values and programs. This connection is often missed by many U.S. supporters of economic sanctions against the Chilean military regime. It is not missed by

1. In 1989 the Chilean people will vote for or against a candidate selected by the military. If they vote "No," a general election will be held in the year following. If they vote "Yes," the military candidate, very likely to be Pinochet, will serve an eight-year term.

the far left in Chile, which is skilled at exploiting economically desperate people to achieve its anti-democratic objectives.

Thus the State Department's position may help polarize Chilean society at a time when a genuine consensus between the moderate political parties and the military seems possible. And polarization will only ensure greater violence by the extremists and, contrary to stated U.S. objectives, hinder progress on human rights and the transition to democracy.

CHILE'S ECONOMIC MIRACLE

When the Marxist government of Salvador Allende collapsed in 1973, Chile's economy was a shambles. Allende had pursued a socialist program that had produced high unemployment, shortages of everyday goods, and an inflation rate of over 1,000 percent. The fall of his government was caused as much by country-wide strikes against the government's economic policies as it was by concern over Allende's disregard of Chile's constitutional guarantees.

The new military government, eventually headed by Pinochet, enjoyed enormous popular support and thus was able to adopt what was then considered a radical and experimental economic program, based largely on free market ideas. The new government immediately abolished wage and price controls, denationalized or privatized more than 200 companies taken over by Allende's government, and reduced import tariffs from an average of 105 percent to a flat rate of 10 percent by 1979.

During this same period, Chile's trade balance quickly improved as the value of copper exports doubled from $1 billion in 1973 to $2.1 billion in 1981. Significantly, Chile's nontraditional exports such as fruits, lumber, and fish increased twenty-fold. This reduced Chile's dependence on copper, and copper's share of total exports fell from 80 percent to 40 percent between 1974 and 1981. Even so, when copper prices dropped in 1982 to their lowest level in 50 years, the Chilean peso appeared overvalued, a situation exacerbated by the government's loose monetary policies. Foreign commercial banks refused to lend more money to Chile's overextended banks, many of which collapsed. Then, under pressure from the foreign commercial banks, the Chilean government intervened, assumed the debts of the private banks, and ended up owing foreign creditors $19.6 billion.

Managing the Debt Crisis

Despite the collapse of the country's financial sector, depressed copper prices, and the highest per capita debt burden in Latin America, Chile has managed to pay its debts on time and to promote sound growth policies at the same time. Chile's economic restructuring, achieved with the financial assistance of the World Bank, anticipated the U.S. Treasury's strategy for promoting growth through the Baker Plan. So far Chile is the only Latin American debtor to have adopted such a strategy. By 1985, the economy had begun expanding at a 2.5 percent growth rate; during the first half of 1986 the growth rate exceeded 5 percent annually.

Chile's economic progress has been tied to a structural adjustment program designed by Finance Minister Hernan Buchi and based upon free markets and reduced government interference in the economy. The purpose of the World Bank structural adjustment loan is, in fact, to support Buchi's program and ensure its successful implementation.[2] The program already has surpassed World Bank targets, which makes it technically eligible for the $250 million loan. The main thrust of the program is to promote all exports and to expand other exports than copper. The program includes a reduction of tariffs, a real exchange rate attractive to export-oriented investors, reduction in corporate taxes, and government efforts to coordinate and promote exports by small producers.

To service its foreign debt, the government has adopted a variety of programs to reduce the public sector deficit, such as privatization of social security through individual private pension funds, the sale of stock in publicly owned companies, including banks nationalized in 1982, and the highly innovative debt for equity swaps. The debt for equity swaps, for example, have reduced the foreign debt by $1.2 billion, or 6 percent of its total of $19 billion, by allowing foreign and local investors to trade discounted dollar-denominated Chilean debt notes for equity in Chilean firms.[3]

The government has promoted foreign direct investment in Chile as another means of improving of financial growth and expanding the export sector. U.S. investors account for half of all investments in Chile in 1985, or $1.6 billion, with the value of trade between the two countries reaching $1.5 billion that same year.

Austerity and Social Programs

Social programs, which make up almost 60 percent of the public budget, have been a major priority for the military government and are strongly endorsed by the Chilean people. Family income supplements, free meal programs, emergency employment programs, and education

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2. As defined by the World Bank, "structural-adjustment lending [is aimed] at helping developing countries carry out the difficult process of policy reform in an unfavorable international economic environment." World Bank Annual Report, 1985, p. 52.

3. See, for example, Steve H. Hanke, "Chilean Flight Capital Takes a Return Trip," The Wall Street Journal, November 7, 1986, p. 33.

subsidies are only a few of the government-supported programs. The Chilean government has opposed IMF designs for reducing these programs because it believes that the economic recovery achieved through the structural adjustment program will eventually reduce the need for the programs by creating jobs. The unemployment rate dropped to 12 percent in 1985, thanks to increased prosperity in the construction and agricultural sectors. Further declines in the unemployment rate will depend on the success of the structural adjustment program in increasing export activity. And the program depends on financial assistance, specifically the $250 million structural adjustment loan (SAL) from the World Bank.[4]

U.S. POLICY ON THE WORLD BANK LOAN

Assistant Secretary of State Elliott Abrams told the House International Development Subcommittee last July 30 that, if human rights conditions failed to improve by the time a vote was needed on the World Bank loan to Chile, the U.S. would support a "no" vote. To back up these statements, the State Department reportedly tried to marshal international support for either a "no" vote or an abstention on the Chilean loan. In control of 20 percent of the votes, the U.S. would need backing from a number of other nations. These efforts have not been successful since few nations want loans "politicized." Lacking the international support to block the loan, the U.S. has worked to postpone the vote to maintain pressure on the Pinochet government for such measures as legalizing political parties, ending arbitrary arrests, and moving toward authentic presidential elections. Despite these efforts the vote has been scheduled for November 20, which is within the original time frame.

Although the State Department has taken the lead on this issue, the U.S. Treasury Department is enjoined by human rights legislation to report to Congress on Chile's human rights progress and use such criteria when making economic policy decisions.[5] But because of Chile's welcome commitment to the Baker Plan, Treasury has been

4. According to an IMF source, "the main benefits of the SAL would derive from the support it would provide to the country's adjustment program of export-oriented policies...." President's Report and Recommendations on a proposed Structural Adjustment Loan to Chile, International Monetary Fund, October 4, 1985, p. 22.

5. Legislation in 1977 authorizing funds for multilateral lending institutions contained a human rights provision that directs U.S. representatives of the institutions to oppose loan applications by human rights violaters "unless such assistance is directed specifically to programs that benefit the poor." This law also requires the Secretaries of State and Treasury to report annually to Congress on human rights progress. See PL 95-118, October 1977.

reluctant to give strong backing to the State Department's position. Treasury is concerned that punishing Chile after that country has so successfully restructured its economy to promote growth and still pay its debts would undermine Treasury's efforts to promote the Plan's pro-growth strategies elsewhere.[6] Big debtors such as Mexico, for example, have been slow to adopt genuine economic reforms despite billions of dollars worth of credits to encourage them to do so. If Chile goes unrewarded, Mexico and other debtors will be unwilling to assume the difficult task of economic restructuring. Without the resultant growth, the debt crisis will worsen and the financial burden on the U.S. government, which is backing credits to such debtors as Mexico, will increase substantially.

Treasury also may be worried that basing Chile's loan on human rights criteria could put World Bank and other multilateral loans to Mexico under closer scrutiny by members of Congress, who are critical of the Mexican government and U.S. policies toward it. The Mexican government's repressive measures against its democratic opposition, reports of arbitrary arrests, torture, and murder by Mexican officials have cast a shadow on U.S. efforts to bail Mexico out of its severe financial crisis. Without the multilateral loans and without U.S. backing, Mexico's rescue package of almost $12 billion will collapse.

The likely outcome will be a compromise between Treasury and State to support an abstention on the loan. Pressure from members of Congress for a vote against this and other loans to Chile will continue, however. Later this year there will be a vote on an Inter-American Development Bank loan to Chile of $280 million.

WHY U.S. SANCTIONS WILL HURT CHILEAN DEMOCRACY

Economic sanctions for human rights objectives will weaken progress toward democracy in Chile by enhancing Pinochet's power, strengthening the violent left, weakening the economy, and undercutting U.S. influence over major political and economic actors, who are crucial to the peaceful transition to democracy in 1989.

As such, sanctions will harm the prospects for democracy in Chile for seven reasons:

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6. U.S. Assistant Secretary of the Treasury David C. Mulford cited Chile specifically as a model debtor and example for other debtors in a speech on May 16, 1986, "I would encourage other debtor nations to follow Chile's example....part of the attraction in Chile is of course its open market oriented investment regime...." See David C. Mulford, "Strengthening the Global Economy," May 16, 1986, p. 7.

1) Sanctions could alienate the most important element in the difficult transition to democracy: the military, particularly the Army. Like most Chileans, the Army resents direct U.S. pressure and probably would close ranks against the U.S. in favor of Pinochet. This will be a significant setback for the U.S. Recently, members of the Armed Forces have indicated their ambivalence toward Pinochet's plans to stay in power beyond 1989. This ambivalence has provided the principal window of opportunity for the U.S. and other actors pushing for democratic change in Chile. An abstention will not minimize the damage to vital U.S. and Chilean military channels of communications and will seriously undermine positive U.S. influence in the democratic process.

2) The U.S. position on the loan will affect its relations with other sectors of Chilean society, including prominent business leaders and associations. Business has been very outspoken in its opposition to the U.S. sanctions. Recently, drivers affiliated with a major trucker's union blocked major highways to protest U.S. economic sanctions. U.S. efforts against the loan could undermine U.S. efforts to push business leaders influential with the government into a more constructive political role in the democratic process. The U.S. Chamber of Commerce in Santiago also has been highly critical of the U.S. stance. And the opposition parties, excepting the Socialist and Communist Parties who have little public support at the moment, also do not endorse the U.S. position.

3) If Chile does not receive the financial assistance it needs, its economy could slow to a 1 to 2 percent growth rate, and Pinochet, increasingly under political pressure, may no longer feel he can survive the long-term adjustments required by the new economic program. To shore up political support, Pinochet may feel compelled to adopt wage and price controls, raise tariffs, and spend scarce foreign reserves on popular programs. This will enhance his control over the economy and lead Chile down a statist path. And greater control over the economy will mean greater power overall for Pinochet, and he will be less easily induced to step down in 1989.

4) U.S. action against the World Bank loan would adversely affect Chile's investment climate, which has improved markedly in the last year. (Chile is one of the few debtor nations to have reversed capital flight.) But Chilean bankers have expressed the fear that U.S. investments in major projects would be withdrawn if the U.S. withdrew support for the World Bank loans to Chile. A poor investment climate also would increase capital flight, which would hurt the value of the Chilean peso and undermine Chile's capacity to repay its debts. Speculation on

the U.S. vote has already caused a devaluation of the Chilean peso against the dollar on the black market.

5) The structural adjustment loan (SAL), if denied, will hurt the poor in Chile. In its 1985 Annual Report, the World Bank emphasized the poverty-reducing role of SALs: "SALs are intended to reestablish a policy framework more favorable to growth, and growth is a prerequisite to the alleviation of poverty." The Chilean government has been able to keep intact its hefty social programs because it has been able to rely on international financing to make adjustments in other areas of its economy.

6) As conditions worsen for the poor, the Communist Party and other far left groups will be able to mobilize greater support among the poor. Not surprisingly, the leaders of the far left have been the only public supporters in Chile for U.S. economic sanctions against their country. Thus to support economic sanctions will in this case aid the far left and polarize Chilean society--exactly the opposite of the Reagan Administration's goals of promoting a peaceful transition to democracy.

7) The structural adjustment loan is only a part of a carefully constructed financial package agreed to by Chile and its creditors. It is intricately tied to IMF assistance and new and rescheduled loans from foreign commercial banks, particularly U.S. banks. Blocking this loan could precipitate the collapse of Chile's foreign financial arrangements, which would force Chile to fall back on its domestic reserves, leading it to miss the IMF targets, which would cause the commercial banks to withhold loans designated for Chile. U.S. banks, for example, through the New York-based steering committee that represents major U.S. banks, voiced doubts about releasing the final $49 million tranche of new money in the 1985 economic package, following Assistant Secretary Abrams' statements to the House Foreign Affairs Committee last July. Without this financial assistance, Chile may decide it has to take the radical step of a debt moratorium. At the very least, the military government would enforce the policies of a wartime economy, raising tariffs and taxes and generally strengthening its grip over the resources of the country.

CONCLUSION

A U.S. decision to abstain on the November 20 vote and its noisy efforts to block the loan to Chile could hinder seriously the role the Reagan Administration has hoped to play in Chile's movement toward democracy. U.S. ability to prod the military and Pinochet to adopt measures in support of the democratic opposition and human rights is likely to be jeopardized. Ironically, the U.S. also has lost credibility among key sectors in Chilean society, almost all of which support the government's economic programs despite the still difficult conditions in their country.

U.S. critics in Congress and elsewhere will continue to demand economic sanctions against Chile since there are no other levers to push: Chile no longer depends on the U.S. for military assistance and long ago learned to do without U.S. public approval. The Reagan Administration must resist the pressure for punitive economic sanctions and continue to seek ways of aiding the Chilean people in their determined effort to restore democratic rule to their country without undermining their equally hard effort to improve their economy. Pinochet's intransigence, although bolstered by increasing violence by the left, is not going to stop the Chilean people from eventually returning to democracy. The U.S. must let them decide for themselves how and when this inevitable change is to occur.

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