

A Fascinating History of Chile's Economic Reforms and Reversals*

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Sebastian Edwards:

The Chile Project: The Story of the Chicago Boys and the Downfall of Neoliberalism
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Introduction

On November 3, 1970, Marxist Salvador Allende was elected president of Chile. He quickly acted to move Chile's economy far towards socialism. He nationalized major industries, expropriated farmland, imposed price controls, imposed heavy restrictions on imports, and substantially increased the money supply. The results were what an economist would expect. Price controls caused shortages in a number of markets and increasing the money supply by 136 per cent in 1971, 178 per cent in 1972, and 365 per cent in 1973 caused triple-digit inflation. The disruption of the economy, the high inflation, and the government confiscation of private property led to widespread dissatisfaction and strikes. On September 11, 1973, Chile's military, led by its Commander in Chief, Augusto Pinochet, overthrew Allende. That same day, Allende, rather than being captured, committed suicide. There followed 16 years of dictatorship until democracy was reintroduced in late 1989.

Even before Allende was elected, several economists who had received their graduate economics training at the University of Chicago had worked in the background to reform Chile's economy in direction of free markets. Of course, Allende did not listen to them, but once Allende was gone, General Pinochet was more open. Over the years, a number of reforms they advocated were implemented and had mainly beneficial economic effects.

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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One economist who was a teenager in Chile during the Allende years was *Sebastian Edwards*, now an economics professor at the University of California at Los Angeles. Edwards has written a book that has been badly needed: a fairly objective analysis of the economics and politics of economic policy in Chile over the last number of decades. Edwards documents the harmful effects of Allende's interventions, the economic reforms proposed by and somewhat implemented by Pinochet and even by later nominally socialist governments, and the effects of these reforms on Chile's economy. He shows that the reforms made Chile's economy the jewel of Latin America. He also shows, though, how the reformers dropped the ball. They failed to stay active in the debate over policy and they paid little attention to the increasing demand for reducing economic inequality. The result was a strong and violent backlash. One of the main lessons from his book is that economic freedom is always at risk and must always be vigorously defended.

What follows is taken from Edwards's book, with occasional commentary by me.

The Chicago Boys

In 1956, the University of Chicago made an agreement with the Pontifical Catholic University of Chile, often called Catolica. The idea was to bring promising students from Chile to the University of Chicago where they could learn economics from Chicago's fairly free-market oriented economics professors and then return to Chile. One of the Chicago stars, even then, was *Milton Friedman* who was to later win the 1976 Nobel Prize in Economics. In September 1956, the first cohort of students arrived in Chicago. Just two years later, they returned to Chile where they became full-time members of the economics faculty of Catolica. The students, all but one of whom were male, came to be called "the Chicago Boys."

In 1969, in preparation for the 1970 presidential election that Allende ended up winning, the Chicago Boys put together a set of economic proposals for the presidential campaign of conservative Jorge Alessandri. They proposed reducing tariffs, deregulating the economy, ending most price controls, and allowing the exchange rate to adjust in response to market forces. Their proposals were not well received. In fact, when Alessandri heard the proposals, he said to his aides, "Get these crazy men out of here; and make sure they never come back."

The "crazy" Chicago Boys, though, had the last laugh. Their 1969 proposals were the basis for the proposals they made in late 1973 to the military government that had deposed Allende. One prediction they made during the Allende years gave them credibility. In early 1972, when inflation was "only" 35 per cent, the Chicago Boys applied the tools they learned at Chicago to predict inflation. When they had studied there, they learned the view that monetarist Milton Friedman believed:

if the money supply increases by a large per cent, the price level will, with a lag, increase by a large per cent. On that basis, with the money supply having grown by 136 per cent in 1971 and even more in 1972, they predicted a 180 per cent inflation rate for 1972. In response, the Allende government had accused them of a “campaign of terror.” In fact, they had *underestimated*: the inflation rate for 1972 was a whopping 260 per cent.

The Brick

Three days after the 1973 coup, the leader of the Chicago Boys, *Sergio de Castro*, was appointed as senior adviser to the new minister of economics, General Rodolfo Gonzalez. According to Edwards, de Castro quickly realized that this was not a job offer but, rather, a military order.

De Castro rose to the task. They put together the earlier-mentioned proposals that had built on their 1969 proposals. The result was a massive document that came to be called El Ladrillo (the Brick.) When de Castro first met Gonzalez, the General had a copy of the document in his hands but didn't, at that time, know that de Castro was the Brick's main author. The authors of the Brick had made proposals in many areas, too numerous to list here. The highlights were the elimination of import quotas and a reduction of tariff rates to a uniform 30 per cent, a devaluation of the currency, and elimination of many price controls. Edwards puts these proposals in perspective, arguing that they were “middle-of-the-road.”

One good effect fairly quickly was that businessmen no longer had to approach the government to justify price increases. Edwards tells an amusing story about businessmen from the cooking oil industry having to meet with de Castro three times before they finally believed his statement at the first meeting that they were free to raise prices and that imports would constrain their ability to set supracompetitive prices.

Milton Friedman's Proposed Shock Treatment

On March 21, 1975, Milton Friedman, probably the most famous economist of the last half of the 20th century, visited Chile and spent an hour talking to General Pinochet. During that meeting, Friedman said that the only way to get Chile's 350 per cent inflation rate down quickly was to apply a “*shock treatment*”. Friedman argued correctly that inflation was so high because Chile's central bank was printing money to finance a budget deficit that was 10 per cent of GDP. Friedman calculated that to run a balanced budget and thus avoid the need to print money would require a 25 per cent cut in overall government spending. Friedman argued that the short-run pain, in the form of high unemployment, would be high, but that the

long-run gain – low inflation and higher economic growth – would make the pain worth bearing. Friedman also advocated opening Chile's economy to free trade, ending price controls, deregulating the economy generally, and privatizing state-owned enterprises. In short, Friedman advocated, and went beyond, much of what was in the Brick although, according to Edwards, Friedman had not read the Brick.

Pinochet did not take all of Friedman's advice, but he did cut domestic government spending by 15 per cent across the board. Also, price controls were ended, the requirement to get a license to import was abolished, import quotas were eliminated, and tariffs were reduced substantially. Also, most of the firms that Allende had nationalized were privatized. The unemployment rate rose from about 10 per cent in 1974 to over 20 per cent by 1977 and then fell to about 15 per cent by 1980. My guess is that Friedman did not expect the unemployment pain to last as long as it did. At the same time, economic growth increased. Real GDP grew by 9.8 per cent in 1977 and 8.5 per cent in 1978.

Friedman's visit led to a lot of controversy, a controversy that was heightened by the announcement of his Nobel Prize in October 1976. A number of previous Nobel prize winners, although none of them recipients of the economics prize, denounced Friedman in a letter to the *New York Times* because he had spoken to a dictator who had killed and/or tortured thousands of people. But Friedman, always the scrapper, defended his visit. He pointed out that he had visited the Communist leaders of China, whose government had killed millions of people, and had heard not a peep from the same people who denounced his Pinochet visit.

Edwards' treatment of the aftermath of the Friedman visit was the one part of the book that I found unsatisfying. Edwards writes, "But deep inside, Friedman was bothered by the Chilean episode." How did Edwards know what was deep inside Friedman? He doesn't say. The closest he comes to explaining his conclusion is his observation that every time he talked to Friedman about Chile and Pinochet, he "noticed some discomfort and uneasiness." Could it be that Friedman was tired of being attacked for, or even asked about, this? Edwards doesn't seem to consider that possibility.

Edwards does highlight one nice thing that Friedman did for someone whom Pinochet oppressed. In July 1976, three months before Friedman was announced as the Nobel Prize winner, Albert Fishlow, an economic historian at the University of California, Berkeley asked Friedman to help obtain the release from prison of Chilean economist Fernando Flores, a former minister of economics and finance in Allende's government. In August 1976, Friedman wrote an impassioned letter asking for Flores's release and he was released later that month.

Friedman's Exchange Rate Contradiction

Milton Friedman was known for being one of the earliest advocates of floating, rather than fixed, exchange rates. In a famous 1959 article, he made a strong case for floating rates determined by changes in supply and demand. In doing so, he argued against the mainstream view that the Bretton Woods system of fixed exchange rates was better. Therefore, I would have expected Friedman to argue for Chile's government to allow its peso to float. But, notes Edwards, he didn't do that. In a 1981 paper that he presented at the Mont Pelerin Society meetings in Chile, Friedman argued that Chile should peg its currency to that of a major country and that *it had done so*. But Edwards points out that it hadn't done so and, in fact, had a "crawling peg," an exchange rate that was designed to change in discrete steps. Moreover, notes Edwards, in his 1998 autobiography, *Two Lucky People*, co-authored with his wife Rose, Friedman wrote, "I have consistently taken the position that a country like Chile with a central bank should let its currency float. The alternative is to abolish the central bank and unify its currency with that of its major trading partner." As noted above, Friedman was not consistent. I'm genuinely puzzled. I knew Milton Friedman well from when I first visited him in 1970 to a last conversation with him a year or two before his death in 2006, and I've never known him to compromise his views to fit those of others. Is it possible that he thought he would undercut some of his former students if he advocated a float? We may never know.

What Friedman did point out that was absolutely correct is that if you keep your exchange rate fixed, then a decline in demand will force down domestic prices and wages. The problem was that in 1979, Jose Pinera, the minister of labor, had persuaded Pinochet to change the labor law to make wages inflexible. Specifically, during contract negotiations, firms were required to offer wage increases that were at least as high as the inflation since the previous contract. When the demand for copper, Chile's main export, dropped during the early 1980s worldwide recession, wages for copper workers and workers in related industries couldn't drop. As a result, the unemployment rate shot above 25 per cent in the early 1980s. To put that in perspective, I note that the peak U.S. unemployment during the Great Depression was 25 per cent.

One other major reform, also due to Jose Pinera, that seemed reasonable in prospect but didn't work out well, was pension reform. In the early 1980s, Chile's government allowed private pensions to which workers could contribute 10 per cent of their pay and could invest in assets. This was very different from the pay-as-you-go Ponzi schemes that the United States and many other countries have. The problem, writes Edwards, was that 10 per cent was too low if workers' goal was

to have a retirement income anywhere close to their income in their last years of work. As it turned out, the pensions were typically only about 25 per cent of the workers' previous pay.

Edwards notes several problems with the private pension funds. He points out that the managers of the fund charged an excessive fee for managing. He doesn't give the number though. If it were as high as one per cent per year, that would have reduced returns substantially. One per cent per year doesn't add up; it compounds up. Another problem is that the assets in which the funds could invest were severely limited. For the first nine years, they were prevented from investing in foreign assets. The limit was gradually increased to a paltry six per cent in 1996, 30 per cent in 2004, and 45 per cent in 2008. Requiring that most investments be in domestic assets prevented people from investing in the booming stock markets of the United States and other countries.

How Chile's Economy Performed

Between 1973 and 1990, before Chile went back to a democratically-elected government, freer trade, ending most price controls, and privatization worked. During that time real GDP per capita rose by 33 per cent, which amounts to 1.7 per cent per year, not high, but respectable. Inflation fell from 508.1 per cent to 27.3 per cent. The per cent of the population in extreme poverty fell from 21 per cent to 13.8 per cent. The unemployment rate rose from 4.8 per cent to 7.8 per cent, which is bad but not terrible. Real wages rose by 143 per cent.

The Left Takes Over

In 1990, Patricio Aylwin of the Christian Democratic Party was elected president. He was followed by a series of leftists: Eduardo Frei Ruiz-Tagle of the Christian Democratic Party and Ricardo Lagos and later Michelle Bachelet, both members of the Socialist Party. As would be expected, all four expanded the size of the welfare state. Interestingly, though, both Lagos and Bachelet carried out some of the reforms advocated by the Chicago Boys. They cut tariff rates and privatized water and sewage provision, for example.

The economic results of staying the course on trade, inflation, and privatization were generally quite good. Between 1990 and 2019–2020, real GDP per capita rose by 131 per cent, for an average annual growth rate of 2.8 per cent. Inflation fell from 27.2 per cent to 2.9 per cent. The unemployment rate did rise, from 7.8 per cent to a worrying 10.8 per cent. Real wages rose by 112 per cent, a 2.5 per cent annual average growth rate.

But there was trouble. The far left didn't like free markets and argued against them. Rather than being happy about the dramatic fall in extreme poverty – it had hit 0.7 per cent by 2019–2020 – they focused on income inequality. The Chicago Boys hadn't cared much about inequality; they presumably thought that as long as virtually everyone was becoming better off, inequality didn't matter. On that, I agree. Unfortunately, a very vocal and somewhat violent group in Chile disagreed.

As a result, Gabriel Borice, a former left-wing student activist, was elected president in December 2021. Presumably, he thought he had everything going for him. But he did get one surprise. A constitutional convention had begun its work on July 4, 2021, at the same time that 2021 presidential election campaign was beginning. The members leaned heavily left and the final document showed it. It contained provisions for a dramatic increase in the size and expense of the welfare state, weakened property rights, and increased monopoly power for labor unions, to name three. But then Chileans started reading it and, when they got to vote on it on September 2022, rejected it by a lopsided vote of 62 to 38 per cent. This has put the brakes on the more extreme policies that many pro-freedom people had feared.

An Aside on Arnold Harberger

One of the University of Chicago economists who was very important in teaching the Chicago Boys and in helping free the Chilean economy from government control was Arnold Harberger. Edwards got to know Harberger in 1976 when he was assigned to be his assistant, and his affection for Harberger shows. I've gotten to know him too and I understand the affection. Harberger is a great economist and a passionate believer in freeing economies so that they work for everyone.

The Debate Never Ends

Nevertheless, Edwards is pessimistic about the future of freedom in Chile. In his final chapter, he predicts that Chile will move even further away from free markets.

Why? One main reason, Edwards argues, is that the pro-market side has abandoned the debate. He writes, "While Far-Left activists mastered Instagram, Twitter, and TikTok and used them brilliantly to get out their gospel, the old guard of free-market supporters stood on the sidelines, and, at most, wrote an occasional letter to the editor." One ominous indicator, writes Edwards, is "Catolica's almost complete disappearance from day-to-day economic policy debates." The younger faculty are immersed in a publish-or-perish culture.

What should be done? Edwards quotes from an interview he did with free-market economist, Deirdre McCloskey, who was an important faculty member at the University of Chicago in the 1970s and 1980s. The answer to the attacks from far-left activists, she stated, is to “preach, preach, and preach”. Amen.