PN-ABI-358

CI Foreign trade,import substitution and aid strategy
382.0983 Mikesell, Raymond F.
M636 Foreign trade, import substitution and
aid strategy: Case of Chile. 1966.
40 p. and tables.
1966 summer research project.

1. Foreign trade - Chile. 2. Export sales - CL. I.
Summer Research Project, 1966. II. Title.

CL
382.0983
M636

FOREIGN TRADE, IMPORT SUBSTITUTION AND AID STRATEGY: THE CASE OF CHILE

Raymond F. Mikesell*

SUMMARY

Chile has made no progress in expanding non-mineral exports over the past fifteeen years. A continuation of this pattern has serious implications both for Chile's balance of payments and for her development. Exports are of special importance for the expansion of Chile's manufacturing sector, which along with agriculture has been lagging relative to construction and services. Chile will not be able to achieve an expansion of exports consistent with a reasonable rate of growth without a drastic change in her trade and foreign exchange policies. Moreover her policy of import substitution has not only failed to promote an adequate expansion of industry, but has led to a misdirection of investments.

Chile has a controlled fluctuating multiple exchange rate system and an overvalued rate for current transactions. She has neither the advantages of exchange stability nor those of an equilibrian rate achieved through exchange rate flexibility. Chile's industry is one of the most highly protected in the world, but her system of import restrictions is complex, uncertain, and irrational from almost any point of view. Her import substitution policy apparently takes no account of the relative efficiency of the industries protected, and in some cases apparently little account of the indirect foreign exchange cost of domestic production as against imports. The relatively high duties and other restrictions on industrial raw materials not only tends to reduce the effective degree of protection given to manufactures, but reduces the competitive position of the more efficient industries that might be capable of producing for export.

Without denying that a rational policy of import substitution is possible, such a policy must be one which encompasses the principle of balancing the use of resources for import substitution against the use of the same resources for expanding exports for purchasing the same goods through imports. All too often, as in the case of Chile, there is a segregation of the domestic from the foreign market with a view to promoting certain industries for exports while keeping the bulk of production non-competitive with external goods. This is not likely to work for a number of reasons, one of which is that a dynamic export industry usually grows out of one which initially serves the domestic market as a successful competitor with imports. Thus an open economy is an important condition for the expansion of exports of manufactures. An open economy is also a sine qua non for a viable Latin American common market.

---

* The views presented in this paper are the sole responsibility of the author. The paper was prepared for the United States Agency for International Development, Office of Program Coordination, as the author's contribution to the 1966 Summer Research Project sponsored by that office.

A.I.D.
Reference Center
Room 1656

My major conclusions and recommendations relate to the employment of the AID program for promoting rational import and exchange rate policies. These recommendations are not based on a doctrinare preference for freer trade; a radical change in the external economic policies of most Latin America countries is a necessary condition for the realization of our foreign aid goals. My recommendations may be summarized briefly as follows:

1. Countries receiving foreign assistance should be asked to agree to a specific time-table of tariff reform involving the elimination of prohibitive duties and a scheduled reduction of all duties on manufactures and industrial raw materials above an agreed minimum, plus the removal of all quantitative, licensing, and other non-tariff restrictions on these items. Luxury imports which the government desires to prohibit or drastically restrict, should be subject to excise taxes on domestic production equal to the effective rate of tariffs on imports.

2. Since import liberalization would be an essential condition for continued disbursements on all program loans, special program loans for liberalizing imports of capital goods and raw materials for the private sector would be unnecessary. Such a regime would of course force countries to adjust their exchange rates to a level consistent with a liberalized import system. Program loans ought to be more specifically related to sectoral programs. In this connection greater use should be made of development banks for channelling funds into private industry and agriculture.

3. Foreign aid should not be provided directly or indirectly to industries which would not be expected to compete successfully with imports, the effective duties on which were in excess of an agreed maximum. Priorities for assistance should be given to industries potentially capable of competing in regional or world markets. Guidelines reflecting these requirements would be established for the use of aid funds by development banks and government development corporations in making sub-loans to industry.

4. In order to discourage countries from seeking funds from foreign assistance institutions solely for infrastructure or other non-industrial projects as a means of avoiding the guidelines, foreign assistance agencies should establish the principle that over a two year period, a minimum proportion of aid disbursements to each country must be for assistance to manufacturing industries which meet the announced guidelines.

5. The United States should in cooperation with CIAP, announce that a fundamental condition of progress for individual members of the Alliance and of the region as a whole through economic integration, is the elimination of quantitative import restrictions and excessive or prohibitive rates of duty. Latin America countries should be encouraged to reach an agreement on maximum ad valorem duties on imports from any source, as an important part of a program of preparation for a common external tariff. As a means of encouraging action along these lines, AID along with other foreign assistance agencies, should announce that after one year, aid funds would no longer be made available directly or indirectly to industries whose products were subject to more than a certain level of protection and that this maximum rate of protection would be reduced from year to year.

Raymond F. Mikesell*
Department of Economics
University of Oregon, Eugene
August 11, 1966

Preliminary Draft -- Not to be quoted

FOREIGN TRADE, IMPORT SUBSTITUTION, AND AID STRATEGY: THE CASE OF CHILE

Introduction

The purpose of this memorandum is to identify a number of problems and policy issues relating to the foreign sector of Chile as a basis for the formulation of AID strategy. My concern here is mainly with import substitution and non-mineral exports, rather than with copper. Lack of data and time has prevented the author from testing certain important hypotheses, but their presentation here may suggest the direction of future quantitative research.

Chile's growth pattern has been determined in substantial measure by her mineral exports as the leading sector, first by nitrates until after World War I, and then by copper. Not only has Chile's level and pattern of imports and general economic structure been conditioned by large and fluctuating mineral exports, but the Chilean Government's fiscal operations became geared to earnings from the mining companies and the imports financed by foreign exchange receipts for minerals. These sources of fiscal revenue and foreign exchange earnings not only fluctuate substantially, but have not grown over time at a rate commensurate with Chile's fiscal and import requirements. In periods of declining receipts from mineral exports, Chile has turned to foreign borrowing, which has resulted in a large foreign debt service. Meanwhile the Chilean economy has not been able to adjust to the requirements of a relatively lower reliance on mineral exports. In particular, the

---

* The views presented in this paper are the sole responsibility of the author. The paper was prepared for the United States Agency for International Development, Office of Program Coordination, as the author's contribution to the 1966 Chile Research Project sponsored by that office.

structure of Chilean industry and agriculture has not adjusted to the appropriate pattern of import substitution and export diversification, nor has the fiscal structure accommodated to the rapidly rising public expenditures in the face of fluctuating and slower growing revenues from mineral exports.

In order to deal with frequent balance of payments crises and inadequate revenues, Chile has adopted foreign trade and fiscal and monetary policies which have distorted her economic structure and price system from one which is consistent with growth and the efficient utilization of her resources. Not only has agriculture been lagging, but according to the official national accounts, the manufacturing sector contributed only 24 per cent to gross domestic output in 1965,[1] a proportion which appears to be low in relation to the normal contribution of manufacturing for countries with Chile's per capita output. Manufacturing in Chile has grown slowly over the 1940-1963 period, as compared with other developing countries. For example, the relationship of growth of manufacturing over growth of GNP for the 1940-63 period was 1.13 for Chile, while the average relationship for 27 developing countries was 1.89. Applying this average to the growth of the Chilean economy of 3.6 per cent per annum, the manufacturing sector should have been growing at 6.8 per cent per annum over the 1940-63 period as contrasted with an actual rate of 3.9 per cent.[2] The bulk of the

---

[1] While the share of manufacturing in GDP is believed to be underestimated, the total contribution of this sector is not likely to exceed 30 per cent in the new estimates of national accounts now in the process of revision. The Current Economic Position and Prospects of Chile, Vol. VI, IBRD, July 1966, p. 1.

[2] Current Economic Position and Prospects of Chile, Vol. VI, op. cit., p. 1.

increase in employment in Chile in recent years has been provided by the construction and service industries instead of by manufacturing and agriculture. While there are a number of explanations for Chile's relatively slow rate of growth and of the direction which her growth has taken, Chile's foreign trade and other policies affecting exports and imports have played a decisive role.

The Export Pattern

In 1965, about 70 per cent of Chile's exports consisted of copper, 19 per cent of iron ore, nitrates, and other minerals, 6 per cent of industrial products, and less than 5 per cent agricultural and forest products. (See Table 1.) In value terms, there has been relatively little increase in exports other than copper since the early 1950s. Exports of iron ore grew substantially in the 1960-1965 period over earlier years, but there has been a steady decline in exports of nitrates partially offset by a rise in exports of other minerals (see Table 2). Both industrial exports and agricultural exports as a percentage of total exports have declined steadily since 1950-54 (see Table 3). Thus, in 1950-54, industrial exports represented 9.3 per cent of total exports and agricultural exports 11.2 per cent of total exports. By 1960-65, these percentages were 7.4 and 5.8, respectively, and by 1965, industrial exports represented only 6.0 per cent of total exports, and agricultural exports 4.4 per cent, making a total of 10.4 per cent accounted for by non-mineral exports. While data are not readily available on export prices of Chile's non-mineral exports (and some of the major non-mineral exports in recent years were not significant in the 1950s), there is no evidence that sharp decreases in

export prices played a significant role in this relatively poor performance of non-mineral exports. In fact, most of the major industrial export prices rose in line with other world prices. It is perhaps also significant that non-mineral exports have declined sharply as a percentage of GNP, from 2.2 per cent in 1950-54, to 1.2 per cent in 1960-65. Moreover, exports of industrial products have been declining steadily as a percentage of manufacturing output. Thus, while the manufacturing sector grew from 1940 to 1963 at a rate of 3.9 per cent per annum, there has been little expansion of exports of manufactures over the past 15 years.

Implications for Chile's Growth and Balance of Payments

The importance of the growth of exports to economic development has been emphasized by economists for a number of years. The factors emphasized indlude: 1) the need for broadening the export base as a means of expanding and stabilizing foreign exchange income; 2) the role of exports in the promotion of dynamic industrial growth; 3) the limited domestic market for capital goods and intermediate goods, which necessitates the creation of export markets as a condition for shifting the industrial structural toward these goods; and 4) the gains from trade derived from specializing in products in which countries have a comparative advantage. All of these arguments for promoting exports, including industrial and agricultural exports as well as additional minerals which can be exported at an advantage, apply to Chile.

Although Chile is expected to experience a rapid increase in copper exports over the next few years, both because of the planned increases in investment and for a limited time, at least, higher prices

for copper, in the longer run. Chile must find other sources of export income to supply her growing import and debt service requirements. Various estimates have been given for the demand for copper from the developing countries over the next decade or so, but these appear to range around a maximum of 5 per cent per annum.[3] Assuming that Chile maintained its share of the expanding world copper markets but did not increase non-copper exports, this would mean an average annual increase of about 2.5 per cent (compound) in Chile's total exports over the next decade. The U. S. AID Mission in Chile projects an increase in Chile's copper exports of 4 per cent per annum over the period 1972-1980. However, Chile's foreign exchange requirements for imports alone will be at least as high as her rate of growth, and to this must be added the rising interest on external debt.

It is worth noting that both the World Bank Report on Chile[4] and the U. S. AID Mission in Chile project a rate of growth of non-mineral exports of approximately 15 per cent per annum over the 1966-1972 period, as being consistent with a 5½ per cent per annum growth rate. For the period 1972-80, a 10 per cent annual increase in non-mineral exports is assumed by the U. S. AID Mission and an increase in imports of 5.5 per cent, the same as the projected increase in GDP.

It might be mentioned at this point that estimates of import requirements differ between the projections of the World Bank Report and those of the U. S. AID Mission. Thus, the U. S. AID Mission pro-

---

[3] See, for example, Bela Balassa, Trade Prospects for Developing Countries, Economic Growth Center, Yale University, 1964, p. 306.

[4] Current Economic Position and Prospects of Chile, Vol. III, Table I,9.

jects an increase in annual import requirements for Chile of $139 million between 1966 and 1972, and $133 million for 1971 over 1966.[5] The World Bank Mission estimates that Chile's import requirements will rise from $745 million in 1966 to $963 million in 1971, a rise of $218 million,[6] as against an increase of $133 million projected by the U. S. AID Mission. John Delaplaine of IDB believes that both of these estimates are understated. On the basis of his model, he calculates that Chile's import requirements will increase from $740 million in 1966 to $1220 million in 1972, or by $480 million, using the same growth assumption as in the World Bank and U. S. AID Mission estimates.[7]

Without looking further into Chile's foreign exchange requirements for imports and debt service payments, it is clear that Chile must expand her export base, and achieve a very rapid rate of expansion of non-mineral exports unless foreign aid is available to fill a rapidly widening gap between exports and foreign requirements consistent with a reasonable rate of growth. Since non-mineral exports represented only $71 million, or about 11 per cent of total exports in 1965, the level of $233 million projected by the U. S. AID Mission for 1972 — at which time they would constitute about 20 per cent of total exports — will require a substantial effort during thispperiod. According to

---

5 This projection assumes a 5.5 per cent growth rate, as does also that of the World Bank.

6 Current Economic Position and Prospects of Chile, Vol. III, Table I.10.

7 See memorandum by John Delaplaine, "Comments on Aid Mission Projections," Aug. 1, 1966. Delaplaine's model is contained in his study entitled "The Structure of Growth in Colombia and Argentina," Harvard University Development Advisory Service, Bellagio Conference, June 1966.

the U. S. AID Mission's projection, this would mean a more than tripling of agricultural exports over 1966 (estimated) and a nearly 80 per cent increase ineexports of industrial products between 1966 and 1972. In the light of the virtual stagnation of non-mineral exports during the post-war period, an enormous promotion effort is called for to meet these goals. Yet, as we shall see, even the realization of the projected increases in industrial exports may not be enough for the abhievement of a 5.5 per cent growth goal for Chile by 1972 in the absence of a continuation of aid on concessionary terms.

Much has been written about the importance of exports for stimulating industrial output once the initial stimulation from import substitution has worn off and the industries begin to stagnate. While a variety of explanations have been advanced for the relatively slow rate of growth in Chile's manufacturing sector and the existence of substantial unused plant capacity, insufficiency of domestic demand has been found to be the major single factor in under-utilization of capacity.[8] The U. S. AID Mission's projection for Chilean growth, 1966-1972, calls for an 11 per cent per annum increase in domestic income generated by manufacturing, and a substantial shift in the direction of investment and output from the construction and service industries to manufacturing. The official Chilean plan for 1966-70 calls for an annual rate of growth of 8.8 per cent in value added by manufacturing for the 1965-70 period, as compared with an historical rate of 3.9 per cent per annum (1940-1963), and a 4.8 per cent per

---

[8] See Instituto de Economia, Universidad de Chile, Utilizacion de la Capacidad Instalada en 42 Empresas Industriales, Santiago, Chile, 1963.

annum growth in manufacturing over the 1960-1964 period. With an assumed annual rate of growth and consumption, 1966-72, of 4 per cent per annum (U. S. AID Mission projection), it is difficult to see how the effective demand for manufactures can increase at the projected rate without a substantial rise in industrial exports. Under the U. S. AID Mission projection, some 48 per cent of the projected rise in domestic income is to be generated by the manufacturing sector. In 1966, manufacturing represented an estimated 19 per cent of domestic demand, as compared with a projected 26 per cent for 1972. Obviously realization of this projection calls for a substantial shift in both production and consumption patterns, especially since import substitution does not play a substantial role in this process. It is worth noting that while industrial output is projected to rise by 87 per cent over the 1966-72 period, industrial product exports over the same period are projected by the Mission to rise by only 80 per cent. In absolute terms, manufacturing output is to increase by $840 million, of which only $60 million (or 7 per cent) constitutes increased industrial exports. It is difficult to see how the projected expansion in industrial output can take place without a higher rate of growth in industrial exports.

As one of the more industrially advanced of the developing nations, Chile is seeking to shift her manufacturing output toward a higher proportion of intermediate and capital goods, so that projected rates of growth in such industries as paper, chemicals, metals, and metal products are considerably higher than those for the traditional consumer goods industries such as food products, textiles, and wearing apparel. However, with a population of under 10 million and a GNP

under $6 million, the domestic market is insufficient to support plants of optimum size for a wide range of intermediate and capital goods as well as for many consumers goods. Thus, without exports, Chile is greatly limited in the number of manufactured items she can produce at costs comparable to those in world markets. Without exports Chile cannot even produce on a competitive basis those products in which, as a consequence of lower raw material costs, she has a potential comparative advantage. The increasing complexity of modern industry requires that even the largest and most industrially advanced countries like the United States engage in specialization and trade. Failure to do so would greatly increase costs and hamper economic progress. For small industrializing countries, specialization and a high proportion of exports to industrial output is a sine qua non of economic progress.

Chile's plan calls for a significant increase in exports of a few industrial products, including paper, steel, and petrochemicals. In my estimation, Chile must have a far broader export base in the field of manufactures, looking toward exports of at least some portion of her output from most of her major industries. This is because the number of specialized products required from each industry is so large that it will not be possible to produce economically more than a fraction of these items on the basis of the domestic market alone. Thus within each industry there must be specialization and exports along with a continuing rise in imports. This pattern will only be possible if most industries are generally competitive, at least within the LAFTA area, and not too far out of line with costs in the industrially advanced countries.

All too often development plans are based on a calculation of import requirements for inputs which are either not expected to be produced within the country, or will not be available from domestic resources in sufficient supply. An effort is therefore made to expand certain industries whose products are designed for export as a means of providing foreign exchange to pay for imports not available from domestic sources. This approach is usually accompanied by a policy designed to keep out imports available in sufficient quantity in the domestic economy for the operation of the plan. Not only does planning of this type frequently fail in its implementation so that foreign exchange earnings fall short of requirements, but it tends to overlook the gains from specialization and trade and their contribution to productivity and reduced costs through competition. Except for industries which properly qualify as infant industries and require special subsidization over a limited period of time, all industries should be regarded as both potential exporters and as subject to foreign competition. The implications of this principle for foreign trade and import substitution policies will be discussed in the following section.

Chile's Foreign Trade Policies and Practices

Foreign trade performance is mainly a reflection of the over-all economic performance and the policies which determine the success of an economy in making full and efficient use of its resources. In the longer run, resources are transferrable and maximum efficiency requires that the cost of producing a good domestically produced good should be no more than the cost of acquiring that good from abroad by producing

more for export. In the absense of unforeseen and uncontrollable developments, pppr performance in the foreign trade sector is simply a consequence of ppor performance in the internal economy. Inflation, price disparities resulting from internal controls, overvalued exchange rates, and excessive import restrictions create a structure of prices and investment and of demand and supply patterns which not only make for balance of payments difficulties but inhibit progress in the domestic economy. All this is by way of saying that there can be no sharp distinction between internal and foreign economic policies in dealing with the problems of the external sector. Nor is it generally possible to offset misguided internal policies by special policy instruments that relate more directly to the foreign sector. Thus, in considering Chile's foreign trade policies, I shall continually refer to her overall economic policies.

Exchange Rates

Chile has a multiple exchange rate system in which the rates are flexible but are periodically set by the Central Bank, which takes into account bohh demand and supply factors in the exchange markets as well as changes in the domestic price index. The three legal markets are the bankers' spot market; the bankers' futures market, in which importers and exporters contract for the purchase and sale of exchange in advance of the date on which payment for imports is made or exchange for exports is received; and the brokers' market, which applies to most current invisibles and private capital transactions. Virtually all of the merchandise trade transactions are financed through the futures market; transactions in the spot market consist mainly of

purchases by the Central Bank of exchange sold by the mining companies to cover their local costs. The spread between the rates in the three markets is indicated in Table 4.

There are no adequate measures of the degree of overvaluation or undervaluation of an exchange rate. However, there are abundant indications that the escudo is overvalued, and that over the past year and a half, the degree of overvaluation has increased. Thus, taking January 1959 as a base — the month during which Chile's exchange system was simplified and a single rate of approximately one escudo to a dollar established — both the wholesale price index and the cost of living index have tended to increase faster than the rate of depreciation of the escudo. By December 1962, the "real" rate on the escudo as measured by the ratio of the index of the escudo rate to the wholesale price index (January 1959 = 100) had declined to 77 (see Table 5). Although there was some increase in this ratio during 1963 and 1964, between December 1964 and March 1966, the ratio of the nominal exchange rate to wholesale price index, i.e., the real exchange rate, declined from 89 to 72.

There is of course no reason to believe that the rate established in January 1959 was a true equilibrium rate, or that the purchasing power parity method provides a proper measure for determining the appropriate exchange rate forCChile. Throughout this period imports have been subject to very heavy restrictions and internal prices of most manufactures have been well above world prices for these same commodities. It should be emphasized that a true equilibrium rate for a country heavily burdened with import restrictions and subject to a

variety of controls and internal price distortions, cannot be determined with reference to movements of reserves or changes in the overall balance of payments. Thus, for example, even when Venezuela was accumulating substantial foreign exchange surpluses, the rate on the bolivar was not compatible with the development of a competitive industrial sector, nor has it permitted a diversification of Venezuela's exports from an almost exclusive dependence on petroleum and minerals. The point I am making is that the proper exchange rate must be one which is compatible with a structure of relative prices of domestic and internationally traded goods, which will permit the realization of a rational development program and optimum employment of resources.

The Central Bank rations foreign exchange for imports so that the bankers' rate is by no means an equilibrium rate, even within the context of the high levels of customs duties and import surcharges. Central Bank officials have admitted some lag in the rate of devaluation relative to the rise in the price indexes, but argue that a more rapid depreciation would interfere with the stabilization program. The fact is, of course, that the increasing degree of overvaluation perpetuates the structural factors responsible for the continued inflation. The brokers' rate is also controlled by the Central Bank, with the spread between the bankers' spot rate and the brokers' rate currently ranging about 20 per cent. However, the price of foreign exchange on the black market was more than 20 per cent above the brokers' rate in June 1966, and a considerable portion of the tourist and other invisible income appears to be channeled through the black market.

The usual argument for a free market for invisibles is that foreign exchange transactions arising out of invisibles are difficult to control, and the existence of such a market avoids the development of a black market. But in order to avoid a significant black market, capital exports must remain free. Moreover, if the adverse psychological effects of a free market are to be avoided, the free rate cannot normally exceed the controlled rate by more than 10 per cent. Since both the bankers' market and the brokers' market are controlled by the Central Bank, there appears to be little justification for the dual legal exchange system. If there is a desire to tax certain invisible payments and to subsidize tourism and certain capital imports through the brokers' market, the rationale has not been made clear. The combination of the steadily depreciating bankers' rate, the wide spread between the bankers' spot rate and the brokers' rate, and the further wide spread between the brokers' rate and the "illegal" free rate for invisibles, tend to encourage capital flight, which continues to take place on a substantial volume from Chile.

Import Restrictions

Imports into Chile are subject to a variety of charges and restrictions, coupled with an import procedure that tends to be lengthy and complicated. No attempt will be made to provide a comprehensive description of Chile's import system. The Chilean industry is among the most highly protected in the world, and the system of import restrictions, including a long list of prohibited imports, high tariffs and surcharges, advance deposits, and direct import licensing, serve not only to exclude imports of most commodities produced in sufficient quantities domestically, but also increase substantially the cost of imported inputs. Taking account of the various import charges, the IMF has estimated that the landed cost of the average import has increased by something over 40 per cent.[9] However, the average is heavily weighted by imports which come in at relatively low duties and surcharges. For example, several import categories are exempt from both advance deposits and import surcharges, including those of the large mining companies, and imports of government agencies. A number of goods on the conditionally permitted list (where production in the remainder of the country has been officially declared insufficient to cover normal requirements) pay a customs duty of 75 per cent.

An ECLA study of duties and other charges applicable in Latin American countries showed that as of 1960 the unweighted average of Chile's duties and other charges on 125 products was 138 per cent. This figure broke down as follows: 1) primary commodities and capital goods (51 products),

---

[9] Chile (1965) Article XIV Consultations, Feb. 16, 1966, Part II, p. 66.

58 per cent; 2) semi-manufactured and durable consumers goods (43 products), 96 per cent; and 3) non-durable consumer manufactures, 328 per cent.[10] Tariffs are generally 30 per cent on most raw materials and manufactured goods, but with substantially lower and higher rates on many essentials, e.g., foodstuffs and drugs, and non-essential items, respectively. However, foreign exchange surcharges ranging up to 400 per cent of the CIF value are payable on most imports, and in many cases are well above the customs duties. A recent World Bank Report estimated that the combined cost of surcharges and tariffs on imports of capital goods was in most cases upwards to 125 per cent of the CIF value.[11] In addition to a long list of items on which prohibitive advance deposits and surcharges are levied, the Central Bank exercises the power to reject import applications where the value of the applications in a particular import category is more than 5 per cent higher than the monthly average for the same goods imported for the past 12 months. During 1965, import applications amounting to $64 million were rejected. This practice injects a considerable degree of inflexibility into the import system, particularly since when a commodity is rejected, applications for that entire customs category must be refused. Frequently this will retard the expansion of the more productive industries and introduce a high degree of uncertainty into business operations.

Given the existence of an overvalued rate of exchange, it might be argued that Chile requires a considerable degree of protection to equalize the difference between monetary costs at home and abroad. However,

---

[10] Santiago Macario, "Protectionism and Industrialization in Latin America," U. N. Economic Bulletin for Latin America, March 1964, p. 75.

[11] IBRD, Current Economic Position and Prospects of Chile, Vol. III, July 1966, p. 9.

the level of protection is far in excess of what is needed to overcome any conceivable degree of overvaluation of the escudo. This is true with respect to nominal tariff rates and is even more true of effective rates of duty on manufactured products which represent the degree of protection given to value added by manufacturing alone. Thus, for example, if Chile has a 40 per cent duty on imports of manufactures, half of the value of which represents the material inputs on which no duties are levied, the effective rate of protection on value added is 80 per cent. If the material inputs are subject to a 20 per cent duty, the effective rate of protection on value added would be 60 per cent.[12] In a recent paper, Professor Bela Balassa calculates that with nominal tariff rates of 328 per cent (average) on non-durable consumer goods in Chile, the effective rate of tariff on these products would be 672 per cent. Hence, according to Bela Balassa, "for given world market prices, the remuneration paid to domestic factors engaged in the production of non-durable consumer products would appear to exceed that received by factors in foreign industries by 6.7 times."[13]

As will be noted in Table 6, the structure of Chile's duties and other charges on imports tends to follow the usual pattern, with the

---

[12] A shortened version of the formula for determining the effective rate of duty, z, on final product import, i, assuming a single material input, j, with a material input coefficient, a, nominal rates of duty on the final product and the material input, t_i and t_j, and the proportion of the world sale price which is value added by the importing country v_i, all at world prices, is

$$z_i = \frac{t_i - a_{ji}\, t_j}{v_i}$$

See Bela Balassa, "Tariff Protection of Industrial Countries: An Evaluation," JPE, December 1965, pp. 576-577.

[13] Bela Balassa, "Integration and Resource Allocation in Latin America," unpublished paper given at Conference at Cornell University, April 1966, pp. 7-8.

highest rates on traditional non-durable consumers manufactures and the lowest rates on primary commodities and capital goods, with semi-manufactures (other than products of traditional industries) and durable consumers goods (with certain notable exceptions, such as automobiles, which have very high rates) falling in between.[14] It is significant to note that not only are duties on virtually all manufactures extremely high, but that duties on industrial raw materials are also high, including commodities which either need no protection because Chile exports them (e.g., iron ore and lumber), and those which are not available in significant quantities in Chile. Chile's import tax structure is a product of an irrational import substitution policy which takes no account of the relative efficiency of the industries protected, and in some cases apparently little account of the indirect foreign exchange costs of domestic production as against imports. Largely as a consequence of the duty structure, plus a highly overvalued exchange rate, a large number of inefficient, small capacity, high-cost industries have been encouraged to produce for a limited domestic market at the expense of potentially more efficient industries, particularly industries capable of producing for an export market. The relatively high duties on industrial raw materials not only tends to reduce the effective degree of protection given to manufactures, but reduces the competitive position of the more efficient industries which might be capable of producing for export.

---

[14] Although the duties and other charges on imports are those applied in Chile in 1960, in spite of a number of alterations in the amount and nature of the charges and of the substantial devaluation of the escudo, the structure of the charges and in many cases the level as well, remains much the same today.

Chile's industrial structure has been determined not only by import protection but by the allocation of foreign exchange and to a considerable degree by the availability of credit to particular industries and firms within these industries. The allocation procedure followed in the areas of foreign exchange for imported inputs and of credit have been no more rational from the standpoint of promoting the more potentially efficient industries including those capable of exporting, than have the import protection policies. The automobile industry is a good illustration of these policies.[15]

Following the example of several other Latin American countries, the Chilean Government decided a few years ago to prohibit the importation of fully assembled automobiles for ordinary domestic use. Firms were permitted to assemble automobiles (including pick-up trucks) provided they located in Arica, some 1000 miles north of Santiago. The foreign exchange for the imported components is rationed, and the components are subject to customs duties and taxes of about 150 per cent. An important condition for remaining in business is that each year the assembly plant must employ an increasing proportion of nationally fabricated components. Thus, in 1964 the required minimum percentage was about 27 per cent; in 1965 it rose to 32 per cent; and in 1966 to about 45 per cent.[16] As of 1964, some 20 automobile firms were established in Arica and produced 8,180 units in 1963 and 7,558 units in 1964. The operations are quite high cost, partly as a result of the small scale of operations and of consi-

---

[15] See Leland L. Johnson, Problems of Industrialization in Chile: Some Preliminary Observations (memorandum prepared for AID), The Rand Corporation, Santa Monica, California, December 1965.

[16] Ibid., p. 12.

derable unused capacity and partly as a consequence of the high cost of local parts (including transportation from the Santiago area). Dr. Leland Johnson has estimated the cost of a compact-sized American car produced in Arica as follows:

$1200	Imported parts
$1800	Customs Duties and Taxes
$5000	Assembly Costs, Local Parts, Dealer Markup
$8000	Approximate Retail Price[17]

The wholesale price of a fully assembled compact delivered in Chile would be about $2200 as compared to the $1200 cost of the imported components, and it is quite likely that the production of local parts also involves a significant foreign exchange component. Dr. Johnson quite rightly questions the advisability of spending $3000 worth of local resources (assuming that $2000 represents dealers markups) in order to save less than $1000 in foreign exchange. One important objective of the program is to induce the domestic production of components so that eventually most of the automobile components will be fabricated in Chile. But the high duties on all components plus the pressure on the assembly firms to increase the proportion of domestic components has simply resulted in a multiplication of small, inefficient producers of such components in the Santiago area with the high costs passed on to the consumer of the finished car. The system of exchange allocations for imported components has led both to shortages during some periods and high inventories (as a consequence of over-ordering in the light of the uncertainty in the approval of exchange applications) in others.

---

[17] Ibid., p. 14.

Imports of industrial raw materials and capital goods at overvalued exchange rates would normally be expected to benefit export industries, or at least offset some of the disadvantage arising from overvalued export rates in relation to the cost of domestic imports. However, as we have seen, this advantage has been nullified by the generally high structure of tariffs on imports, both capital goods and industrial raw materials. Where locally produced primary products are exported at world prices and sold in the domestic market at world prices, the existence of an overvalued rate of exchange tends to benefit exports since any import duties on such commodities are not effective. It is therefore not surprising that most of Chile's industrial product exports, including those exports which the Chilean Development Plan seeks to expand in the future, have a heavy domestically produced raw material content. These products include pulp and paper, iron and steel, petrochemicals, and copper products, as well as processed foods and beverages. It is also worth noting that most of the industrial exports, actual or projected, tend to be rather capital intensive rather than labor intensive. While there is certainly a shortage of capital, the cost of capital to those firms fortunate enough to obtain it either from the government or from the banks, is well below its social cost--in fact interest rates in the organized money market are generally negative.

Legislation which the Chilean Congress approved in June 1966 provides authority for the government to establish a system of drawbacks or tax reimbursements to exporters. (The former system under which drawbacks were originally tied to the amount of specific domestic taxes paid by exporters proved of little value in practice because of administrative complications and uncertainties.) Under the new system exporters will be able to obtain

up to 30 per cent higher escudo returns on their sales abroad, but the selection of the products to benefit and the amount of the drawback applicable to each is left to the discretion of the Central Bank. Past experience with multiple export rates and other devices, however, shows that the obstacles to exports arising from overvalued exchange rates, high import restrictions, and other sources of price distortion cannot be eliminated by administrative tinkering with individual prices.

As has already been mentioned, foreign trade and exchange policies constitute only one set of factors which determine the character of foreign trade. Price controls on agricultural commodities designed to keep down the cost of living have contributed to low investment and output in agriculture which in turn have increased imports and restrained exports of agricultural commodities. The system of credit rationing in the absence of facilities for medium and long-term credit for industries (other than that provided mainly to large and favored firms by CORFO) has meant that capital is not allocated on the basis of its most efficient uses. The same is true of foreign exchange and the availability of imported inputs of all kinds. However, the absence of competition and free entry of firms would prevent a rational pattern of production for export and domestic use in line with Chile's comparative ad-advantage position, even if the exchange rate were not overvalued and a proper import system were established.

Assessing Comparative Advantage

Assessing Comparative Advantage

A fundamental condition for correcting Chile's foreign trade imbalance and for the efficient allocation of Chile's resources is the establishment of a flexible price system, including a realistic exchange rate, the elimina-

tion of the complex of administrative controls, including the rationing of credit and foreign exchange, and the abandonment of the costly, haphazard policy of import substitution. This condition will of course require reasonable stability of both internal prices and the exchange rate. However, these conditions cannot be established overnight, and even if they were, Chile's economy has been in a state of disequilibrium for so long, and her economic structure is in such a high degree of imbalance, that special encouragement will be needed on the part of the governmental planning and credit authorities in order to move Chile along the path of equilibrium and growth. While I am not suggesting that specific credit assistance and other measures designed to achieve a more efficient pattern of investment and output are a substitute for overall reforms which would establish a free and open economy and functioning price system, both government and foreign aid administrators will continue to have an important influence on the economy and there should be guidelines for their operations consistent with the smooth workings of a free and competitive economy.

As we have been told many times, comparative advantage is a static concept. But the fact that there are decreasing costs, external economies, and linkage effects, does not mean that we can justify the production of any commodity a nation decides to produce, or formulate a development program based solely on balanced growth and consistency without regard to efficiency and the maximum returns from the use of resources. In a distorted economy like Chile we do not have enough information to prepare a detailed economic program which will provide the answers as to which industries should be encouraged as potential export industries or discouraged in favor of imports. Some of the answers will become rather obvious once price distortions are

removed, including the undervaluation of capital and foreign exchange. There is a presumption that, given the relative supplies of the factors, Chile would have a comparative advantage in more labor intensive industries, at least as compared with the highly industrialized nations. But abundant and cheap raw materials for industries where such materials constitute a large proportion of total costs, or where transportation is an important cost element, may indicate a comparative advantage in a relative capital intensive industry, such as steel and pulp and paper. It is also sometimes possible to employ techniques involving a lower capital-labor ratio to produce virtually the same product.

In a recent study which he still regards as preliminary, Dr. Hal B. Lary, of the National Bureau of Economic Research, has shown that there exists a broad similarity in the ranking of industries by labor or capital intensities from country to country. Lary plots value added per employee in manufacturing for each of 13 main groups of manufacturing industries arranged (on the abscissa) in an ascending order of average value added per employee in the United States in 1958, for the United States and 9 other countries. Lary finds a broad similarity of the industry rankings among the 10 countries as one moves from industries with low value added per employee to high value added.[18]

---

[18]See Hal B. Lary, Exports of Manufactures by the Less Developed Countries, proposed occasional paper (National Bureau of Economic Research), June 1966. The nine countries are Canada, Australia, Sweden, United Kingdom, Chile, Brazil, Japan, Mexico, and India. The 13 industries in order of value added per employee in the U. S. are 1) clothing, footwear, etc.; 2) textiles; 3) wood products and furniture; 4) leather and leather and fur products; 5) miscellaneous manufactures; 6) printing and publishing; 7) machinery, transportation equipment, and metal products; 8) non-metallic mineral products; 9) rubber products; 10) paper and paper products; 11) food, beverages, and tobacco products; 12) basic metals; 13) chemicals and chemical petroleum coal products. Ibid., p. 17A.

Thus, in all cases, textiles have a relatively low value added per employee ($5000 for the U. S. and less than $400 for India), while chemicals and basic metals have relatively high value added per employee in each of the countries. There are outstanding exceptions to the pattern in individual countries, and undoubtedly there would be far greater variations in the pattern if the industry groupings were broken down by individual commodities. Nevertheless, the similarity of the ranking of industries by value added per employee among countries seems good enough to suggest that an industry with low value added per employee in the United States, Canada, or Western Europe, would be a good candidate for exports from the less developed countries. This position is strengthened by the labor shortages and rapid increases in real wages in the industrialized countries. Furthermore, the argument is strengthened by the fact that imports of manufactures by the developed from the less developed countries tend to be concentrated in industries with less value added per employ.[19] Conversely, it would appear that less developed countries with an abundance of labor and a shortage of capital should ordinarily avoid industries which are characterized by quite high value added per employee in the United States and other industrialized nations.

At my suggestion, Mr. John Cownie sought to apply the above tests to Chilean manufactures, i.e., to determine to what degree Chilean manufacturing is concentrated in those industries which in the United States have a less than average value added per employee. (Labor-intensive). Cownie's investigation[20] showed that in 1965 Chilean manufacturing was about evenly divided

---

[19] See Lary, op. cit., p. 27A, Table III.

[20] See memorandum by John Cownie entitled "Application of the Lary Model to the Chilean Manufacturing Sector," August 1, 1966.

between those industries which Lary identifies as labor intensive and those identified as capital intensive (having the value added per employee in the U. S. higher than the U. S. average). Cownie also found that there was a strong correlation between labor intensity and "high growth," the latter industries being defined as those having a rate of growth for the 1960-65 period above the average rate of growth of Chilean manufacturing for the period. Nevertheless, there are a large number of capital intensive or high value added per employee industries in Chile, some of which, such as the manufacture of transport equipment and of electric machinery, which are not only capital intensive but do not have a special advantage arising out of relatively large locally produced material inputs. On the other hand, the pulp and paper industry, while capital intensive, does have a significant advantage from the standpoint of proximity of material inputs.

Mr. Cownie also looked into Chile's foreign trade in manufactures.[21] He found that manufactures which are labor intensive according to Lary's definition formed only a small percentage of Chile's non-mineral exports in 1962 and half of these were accounted for by fishmeal, which involves a large raw material input. On the other hand, Cownie found that Chile imports substantial amounts of labor intensive manufacturing, accounting for about 15 to 25 per cent of Chile's total imports in 1962.

Value added per employee in manufacturing provides at best only a rough guideline or basis for preliminary screening, after taking into account such important factors as raw material inputs, transportation, scale or market size, etc. As a member of LAFTA, Chile must consider her comparative advan-

---

[21] See John Cownie's memorandum of August 2, 1966 entitled "Chilean Foreign Trade and Labor Intensive Manufactures."

tage in relation to other Latin American countries as well as in relation to the highly industrialized nations. Except in the case of industries with a high proportion of domestically produced material imports, it is not easy to predict which industries will become important exporters. Moreover, as we have seen in trade among the developed countries of the world, international trade in manufactures is subject to dramatic shifts, depending upon the rate at which innovations take place, the character of management, and frequently unpredictable shifts in demand and supply relationships within individual countries. While it may be possible to plan the growth of certain industries for exports if the bulk of domestic industry is reasonably competitive with the same products sold in regional or world markets, many other industries should become exporters, and investment and output will be adjusted accordingly. Hence, for a wide range of manufacturing, the problem is not so much to choose the most likely candidates for exports and deliberately to plan capacity for that purpose, but rather to make sure that special protection or inducements are not given to firms whose products are not likely to be competitive in world or regional markets.

Import Substitution

Import substitution as a policy for industrial development seeks to provide special encouragement (or protection) for products now being imported with a view to replacing with domestic production commodities currently being supplied by imports, and secondly to meet the growing domestic demand after all or the bulk of the imports have been replaced. The principal arguments for this approach to industrialization are a) the saving of foreign exchange and b) the existence of a well-developed market established by imports. A rational import substitution policy would appear to give priority

to industries in which domestic value added by manufacturing was high and imported inputs per unit of output was low as a means of saving foreign exchange. It would also give priorities to commodities for which the domestic market was relatively large and growing rapidly in order to take advantage of the economies of scale. As a corollary, special priority should be given to industries employing a high proportion of domestic material inputs and to those which require manufactured or processed inputs which have the same characteristics from the standpoint of foreign exchange saving, use of domestic inputs and scale advantages as the final product itself. Finally, a rational import substitution policy would suggest a choice of industries with high backward or forward linkage effects provided the induced industries meet the basic conditions for priority industries as indicated above.

Unfortunately, Chile's import substitution policy has not been rational. Protection has been provided to most any industry that could conceivably operate in Chile, without regard either to net foreign exchange saving or to the size and rate of growth of the domestic market. The automobile industry is a good example, although there are many others. Foreign exchange costs of inputs are high in relation ot value added; economies of scale are ignored in the manner in which the automobile firms were permitted to be established; little domestic raw material inputs were involved; and the industries stimulated by induced by backward linkage were in most cases subject to the same disadvantages as the automobile industry itself.

It is quite possible that a completely rational policy of import substitution which paid attention to all aspects relating to the optimum use of resources could be regarded as defensible. But the basic economic philosophy of the policy of import substitution, which in its most rational form sets forth foreign exchange savings and domestic market size as the primary

consideration for determining industrial priorities, is erroneous. It is fundamentally in conflict with a rational foreign trade policy and the employment of resources for maximum gain. Production for net foreign exchange saving through import substitution must be balanced against the real gains from the use of the same resources for purchasing imports. While it is justifiable to establish many industries which because of transportation costs or other factors may never expect to become normal exporters, it is patently uneconomic to give encouragement to industries which even after they are well established could never compete with imports. Any system of priorities in a program of industrialization, therefore, should place primary emphasis on long-run relative costs and should take into account both the domestic and the foreign market for the product.

One of the difficulties with a policy of import substitution lies in the accompanying attitude toward exports. The export sector is often regarded as something apart from, or at least in a special category distinct from, the bulk of domestic industry.[22]

The export market is regarded as a "vent for surplus" and the idea that the internal and the external sectors should be closely integrated through the price system as is the case to a considerable degree among the industrialized countries of Western Europe, the United States, and Canada, is foreign to this approach. Thus, for example, a Chilean firm,in Industriales Forestales, has built a plant specifically for the exportation of newsprint since the domestic market is reserved for an older firm, Papeles y Cartones. (In ORDER TO OBTAIN THE MACHINERY FREE OF CUSTOMS DUTIES,

[22]For an excellent discussion of the philosophy of import substituions see "The Growth and Decline of Import Substitution in Brazil," Economic Bulletin for Latin America, March, 1964. For a good example of the costs of import substitution see Anne O. Krueger, "Some Economic Costs of Exchange Control: The Turkish Case" (mimeographed). See also Nathaniel H. Leff, Export Stagnation and Antarkic Development in Brazil" (mimeographed).

order to obtain the machinery free of customs duties, Industrias Forestales agreed not to sell on the local market.)

This segregation of the domestic from the foreign market as a part of Chile's policy of industrialization is unfortunate in that it fails to take account of the process by which other countries have become important exporters of industrial products. Historically, developed countries produced industrial products first for their own markets, often as import substitutes, which after a time they began to export, perhaps first to countries at a lower state of industrialization and later on to other highly industrialized countries. This process has been well illustrated by Dr. William V. Rapp in his study, "A Theory of Changing Trade Patterns: Tested for Japan, 1890-1962."[23] Japan first imported manufactures from the more advanced countries, and then developed domestic substitutes, followed later by exports of these same commodities. Japan's manufactured exports tended at first to move to countries less developed than Japan, partly because trade barriers were lower for products not yet produced in these countries, and partly because Japanese quality and marketing techniques were not suitable to mass marketing in the industrially advanced countries. Later on, however, as Japan's labor force became more skilled and educated and as production became more capital intensive and technologically advanced, Japan exported more to the industrially advanced countries. As Rapp points out, at lower levels of income and develop-

---

[23] This study will be published in the Yale Economic Essays next year. A summary of Rapp's dissertation is given in an unpublished memorandum entitled "Trade and Industrial Development: The Japanese Experience," July 1966.

ment Japan's domestic market could not support optimum sized plants for technologically advanced industries. But because Japanese industry was competitive and continually increased productivity and quality, each industry was able not only to export but found markets at a later stage in the highly industrialized countries.

The experience of Japan carries some lessons for trade in industrial products among the less developed countries, and particularly within LAFTA if the area is successful in creating a viable common market or free trade area. As one of the more industrially advanced of the Latin American countries, Chile should initially find it easiest to establish markets for her industrial products in Latin America. Yet it is these very products on which nearly all Latin American countries, including Chile, maintain very high duties or other restrictions.

If Chile were to abandon her import substitution policy, rational or irrational, and adopt instead a truly open economy in which the domestic and foreign sectors were integrated through the price system, what type of import policy should Chile establish? First of all, Chile should remove all administrative inconveniences and delays as well as quantitative restrictions on imports and should establish an equilibrium exchange rate, given the demand for imports as determined by her tariff structure and her foreign exchange availabilities including capital imports. A completely free market for invisibles, including non-registered capital imports and domestic capital exports, should be established in place of the present brokers' market cum

black market. It has been suggested that an equilibrium rate would give too much of a windfall to exporters of mineral products. However, so far as the large foreign firms are concerned, their dollar income would not be affected, although their local costs would be reduced somewhat by a devalued rate. I do not think this is an important consideration since the profits of the large foreign mining concerns are determined by special tax and profit sharing agreements with the government. In the case of the smaller domestic mining firms, higher prices for ore should increase their willingness to invest, and the government should collect a good share of the windfall from increased taxes. The introduction of multiple exchange rates as applied to merchandise transactions would, in my opinion, be a backward step and would interfere with the important job of eliminating existing gross price disparities within the Chilean economy.

Tariff Recommendations

In place of the hodge-podge of tariffs, surcharges, advance deposits, and licensing restrictions, Chile badly needs a rational tariff system, the main outlines of which are suggested as follows. First, tariffs should be abolished on industrial raw materials on the grounds that they are either not needed, because Chile is an exporter of these materials, or if she is a net importer, such tariffs increase domestic costs and reduce the competitiveness of the Chilean industry. (I will not deal in this paper with the problems of basic food imports.) Second, Chile should establish a normal rate of duty which would be the same for all imported manufactures, based on a certain percentage of value added by manufacturing. Thus, if the normal tariff were determined to be 30 per cent and half of the FOB value of an imported commodity represented value added by manufacturing (assuming no duties on imported materials), the appropriate nominal rate of duty would be 15 per cent.

An exception to the rule of a uniform effective duty on all manufactures would be that all imported commodities would be subject to the same rate of excise taxes as might be imposed on internally produced commodities. Thus, if countries desire to discourage expenditures for luxury items such as automobiles and scotch whiskey, they should impose equal rates of taxation on both domestically produced and imported items (in excess of the normal effective duty).

The argument for establishing a standard rate of duty on all manufactured imports by a developing country such as Chile is two-fold. First, newly developing countries are generally less efficient and their productivity lower than is the case with developed economies.

This is a consequence of such factors as the lack of economic overhead facilities, a lower level of skills and education of the workers and managers, smaller scale of industrial operations, absence of vertical integration, and the lack of a variety of factors making for expernal economies which are present in more industrially advanced societies. To a considerable degree, this relatively lower level of industrial productivity is reflected in the exchange rate, and in fact if underdeveloped countries err in setting their rates in relation to the equilibrium level, they should do so on the side of undervaluation rather than overvaluation (as is usually the case). However, too great a degree of undervaluation may have undesirable consequences, such as providing windfall profits to exporters of primary products and giving the primary sector an excessively favorable terms of trade vis-a-vis the industrial sector. In many countries, mining and plantation agriculture operations are quite efficient and do not need a subsidy arising from an undervalued exchange rate. Also, devaluation raises the prices of imported raw materials, which duties on manufactures do not.[28] The second argument for the normal import duty applying to all manufactures is that it provides a basis for a margin of preference in the creation of regional trading groups such as LAFTA. If all countries which became members of a regional preference group were to establish uniform effective rates of duty on manufactures, the problem

---

[28] A frequently voiced argument for protection or subsidization of manufactures is that industrial workers in developing countries are paid wages which are higher than the average marginal social productivity of labor. See, for example, Everett Hagen, "An Economic Justification of Protectionism," QJE, November 1958. In a recent essay Professor Harry G. Johnson has criticized this argument. See Johnson, "Optimal Trade Intervention in the Presence of Domestic Distortions," in Trade, Growth, and the Balance of Payments, 1965.

of formulating a common tariff structure would be relatively easy. This would eliminate the problem which arises when each member of the regional trading group wants to establish a high level of common external duties on those commodities which it produces domestically in competition with imports, but prefers low or no duties on imported commodities which are not produced domestically. Ideally, the normal duty on manufactures should be gradually reduced as the developing country's productivity increases and it would be highly desirable for these reductions to take place automatically, say, every five or ten years. It should never be forgotten that import duties represent a tax on consumers and a subsidy to domestic producers, and the social costs of the tax should always be measured against the expected social benefits.

But why impose a uniform rate of duty on all manufactures? Why not just levy protective duties on some items in accordance with the infant industry principle? My reasons are partly strategic or political, and partly economic. The purpose of the uniform (effective) import duty on all manufactures is to provide a temporary subsidy to compensate for the absence of external economies which constitute some unmeasurable degree of disadvantage to all industries as compared with those in the developed countries. This seems to be a better way to provide a general level of encouragement to industries, all of which make some contribution to external economies, than to single out individual industries, however inappropriate and inefficient for the economy, and give them special protection on grounds that they will provide external economies. (I am reminded of Professor Edward Mason's quip that "External economies is the last refuge of a scoundrel.")

But are there not some industries to which special protection should be given in accordance with the infant industry principle? The propensity of infant industries to grow to manhood without being weaned from the nursery bottle of protection is well known; in fact the larger they get the louder they are able to cry for more protection. Moreover, the more inefficient they become relative to production abroad, the more tariff assistance they are likely to receive as a reward for poor performance. On the other hand, the principle of assisting promising industries and getting them started by means of low-cost credits, tax advantages, and other temporary subsidies which can be adjusted to need with due regard for performance is a good one and should be employed as a substitute for special import protection. The selection of promising industries and firms for credits, tax, or other types of temporary assistance is not an easy process. While there are perhaps some ready rules of thumb, such as the Lary value added per employee test, which might be used to avoid encouragement to the wrong industries, a ranking of industries by priority requires sectoral and industry studies and pre-investment surveys involving considerable time, detail, and expenditure outlay. Such judgments are particularly important in the case of large industrial undertakings where substantial amounts of domestic or foreign public loans may be involved. While such industries must operate within the framework of the price system and interferences with that system should not be employed to cover up mistakes in judgment where public capital or subsidies are involved, important investment decisions involving large amounts of public capital cannot be left solely to the market or determined solely by expectations of private

profit. It is important, however, that the decisions are made within the framework of the price system and on the basis of maximum efficiency in the use of resources.

Implications for Foreign Aid Strategy

If the principles outlined above are accepted, the overriding objective of aid strategy for Chile and other countries with similar economic structures must be the establishment of an equilibrium economy and price system which integrates the internal and external sectors. Reasonable price stability and balanced external accounts in the context of price distortions maintained by a complex of internal and external controls constitute a false equilibrium and one which not only perpetuates a misallocation of resources but will soon generate renewed inflation and balance of payments deficits. The history of foreign aid to Chile must be characterized in the main as one of "aid by crisis." Such assistance is at best a pallative and at worst a mechanism by which the government has been able to avoid fundamental reforms and structural adjustments. A successful aid program for achieving long-run development goals is impossible in a disequilibrium economy. Moreover, economic integration in Latin America will never be anything more than a political slogan until countries integrate the internal and external sectors of their economies through the free operation of the price system.

My specific recommendations for aid strategy as relates particularly to the foreign sector are as follows:

1. The United States should, in co-operation with CIAP, announce that a fundamental condition of progress for individual members of the

Alliance and of the region of the whole through economic ingegration, is the elimination of quantitative import restrictions and excessive or prohibitive rates of duty. Latin American countries should be encouraged to reach an agreement on maximum (effective) ad valorem duties on imports from any source as an important part of a program of preparation for a common external tariff. As a means of encouraging action along these lines, AID, along with other foreign assistance agencies, should announce that after one year, aid funds would no longer be made available directly or indirectly to industries whose products were subject to more than a certain level of protection and that this maximum rate of protection would be reduced from year to year.

2. Foreign aid should not be provided directly or indirectly to industries which would not be expected to compete successfully with imports, the effective duties on lwhich are in excess of, say, 30 per cent. Priorities for assistance would be given to industries potentially capable of competing in regional or world markets. Guidelines reflecting these requirements would be established for the use of aid funds for development banks and government development corporations in making sub-loans to industry.

3. In order to discourage countries from seeking funds from foreign assistance institutions solely for infrastructure or other non-industrial projects as a means of avoiding the guidelines, foreign assistance agencies should establish the principle that over a two-year period, a minimum proportion of aid disbursements to each country must be for assistance to manufacturing industries which meet the announced guidelines.

4. Where program loans are employed, a specific agreement and timetable on tariff reform involving the elimination of prohibitive rates and a scheduled reduction of all rates on manufactures and industrial raw materials above an agreed maximum, plus the removal of all quantitative, licensing, and other non-tariff restrictions on these items, should be included in the CIAP letter of intent. Luxury imports which the government desires to prohibit or greatly restrict would be subject to excise taxes on domestic production equal to the effective rate of tariff on imports.

5. Program loans specifically designed for liberalizing imports of capital goods and raw materials to the private sector would be unnecessary since imports would be free except for duties. Such a regime would of course force countries to adjust their exchange rates to a level consistent with a liberalized import system. Multiple rates applying to imports would be inconsistent with the requirement in (4) above.

6. Assistance to private industry and agriculture should be related to projects and programs involving a package of projects (not specifically identified except for conformance to general criteria). Greater use should be made of development banks and other specialized credit institutions in channeling funds into private industry and agriculture.[25]

---

[25] For a discussion of my views on public external financing to development banks, see Robert W. Adler and Raymond F. Mikesell, Public External Financing of Development Banks in Developing Countries, Bureau of Business and Economic Research, University of Oregon, Eugene, Oregon, 1966; see also Raymond F. Mikesell, Public Foreign Capital for Private Enterprise in Developing Countries (Essays in International Finance), International Finance Section, Princeton University, April 1966.

7. Shortage of local currency capital for the private sector is frequently a limitation on industrial and agricultural development, including production for exports and import substitution. Foreign loans to development banks, which can only be used for sub-loans to cover the foreign costs of investment projects, do not meet the local currency requirements and may lead to a direction of operations toward import-intensive projects. Where development banks are permitted to convert a portion of their loan proceeds into local currency at the Central Bank, the real value of the local currency is less than the value of the foreign exchange when the exchange rate is overvalued. Thus, where the exchange rate is overvalued, development banks should be permitted to convert the foreign exchange proceeds of external loans at a more realistic rate.

8. Without general tariff and import restriction reforms, loans to governments to enable them to liberalize imports of capital goods, spare parts, and raw materials by the private sector may make it possible for countries to perpetuate a regime of overvalued rates and irrational import substitution policies. In the absence of exchange and import reforms, it would be better to restrict assistance to particular industries and firms (either directly in the case of large enterprises, or indirectly through development banks) which meet the criteria of competitiveness outlined above. If this policy results in very few loans being made, pressure might be put on the government to adopt the necessary reforms; at least a misallocation of foreign assistance funds would be avoided.

Table I
CHILE'S EXPORTS BY PRINCIPAL COMMODITIES
(in millions of U.S. dollars)

	1961	1964	1965
Minerals	385	517	611
Copper	299	395 1/	482 1/
Iron Ore	45	70	74
Other	41	52	55
Agriculture and Forest Products	30	32	30
Wool	9	7	6
Fruits and Vegetables (fresh)	16	16	14
Fish and Sea Food (frozen)	1	3	4
Lumber	3	3	3
Other	3	3	3
Industrial Products	37	43	41
Fishmeal and Fishoil	5	19	10
Other Food and Beverages	4	4	6
Pulp and Paper	9	7	10
Iron and Steel	11	3	1
Metal Products	7	6 1/	7 1/
Other	1	4	7
Total	454	592	682

Source: IBRD.

1/ The 1964 and 1965 custom statistics of industrial exports include large amounts of copper with little or no processing exported for its metallic value by Chilean manufacturers of copper products. This copper, estimated by the Mission at $34 million in 1964 and $53 million in 1965, is excluded from the exports of industrial products and included in the minerals category.

Table 2

Exports By Commodity Class
(Millions of dollars)

	Copper	Iron Ore	Other Minerals	Total Minerals	Agricultural Products	Industrial Products	Total Exports
Annual Average, 1950-54	193	10	100	303	43	37	383
Annual Average, 1955-59	265	4	97	366	35	38	439
Annual Average, 1960-65	357	58	48	463	31	36	530
1960	319	38	42	399	30	32	462
1965	482	74	55	611	30	41	682

Sources: Data for 1950-1959 from USAID Mission Data Book; 1960-1965 data from Table 1.

Table 3

Exports of Agricultural Products and Industrial Products as a Percentage of Total Exports

	Agricultural Products (1)	Industrial Products (2)	Total (1) and (2)
Annual Average 1950-54	11.2	9.3	20.5
Annual Average 1955-59	8.2	8.7	16.9
Annual Average 1960-65	5.8	7.4	13.2
1965	4.4	6.0	10.4

Table 4

EXCHANGE RATES, 1960-1966
(Average buying monthly rates)

(Escudos per U.S. dollar)

	Banking Market Spot	Banking Market Futures	Brokers' Market
From January 1960 to December 1961 the exchange rate was fixed at 1.051 1/			
Jan. 1962	1.051 2/		1.42 2/
Oct.	1.286 3/		1.979
Dec.	1.545		2.319
Mar. 1963	1.808		2.999
Mar. 1964	2.296		3.214
Aug.	2.346	2.783 4/	3.225
Mar. 1965	2.901	3.138	3.460
Mar. 1966	3.669	3.742	4.432
Jun.	3.97 5/	n.a.	4.65 5/

Footnotes:

1/ January 1, 1960. A new monetary unit, the Escudo, equal to 1,000 pesos, was introduced.

2/ January 15, 1962. Two exchange markets were instituted, an official market (known as the banking market) with a fixed exchange rate of Esc.1.051 buying, Esc.1.053 selling, and a brokers' market with a fluctuating rate.

3/ October 15, 1962. The official support for the exchange rate in the banking market was withdrawn, and it was announced that this rate would in the future be determined by market forces.

4/ Since early in 1963 exporters (except the large copper mining companies) have been permitted to sell their export proceeds, in advance of receipt, to certain importers, through the intermediary of authorized banks. The futures market was progressively opened for more categories of imports and in September 1965 the access to the market was granted to all importers. Banco Central quoted the futures rate in its Boletin Mensual for the first time for the month of Aug. 1964

5/ End of month.

Source: IBRD and International Financial Statistics

Table 5

COMPARISON OF EXCHANGE RATE AND PRICE LEVEL CHANGES, 1959-66

(BASE: January 1959 = 100)

	(1) Exchange 1/ Rate	(2) Cost of Living Index	(3) Wholesale Price 2/ Index	"Real" Exchange Rates: Consumer Prices (1)/(2)	"Real" Exchange Rates: Wholesale Prices (1)/(3)
January 1959	100	100	100	100	100
December 1960	100	136	124	74	81
" 1961	100	149	126	67	79
" 1962	147	191	163	76	77
" 1963	199	277	229	72	87
" 1964	295	384	330	77	89
" 1965	337	483	437	70	77
March 1966	356	521	494	68	72

Source: IBRD and International Financial Statistics, July, 1966.

1/ For 1959-63, the average monthly buying rate (spot) in the Bankers' Market; for 1964-65, the average monthly buying rate in the futures market.

2/ Domestic Goods

Table 6

SIMPLE ARITHMETIC MEANS OF APPROXIMATE INCIDENCE (IN AD VALOREM TERMS) OF DUTIES AND CHARGES APPLIED IN CHILE TO SELECTED PRODUCTS

Catagory and group	Chile
Category I (51 products)	
Primary commodities and capital goods	58
1. Non-processed foodstuffs (13 products)	46
2. Industrial raw materials (10 products)	111
3. Capital goods (28 products)	45
Category II (43 products)	
Semi-manufactured and durable consumer goods	96
1. Semi-manufactured goods (including fuels), other than products of traditional industries (32 products)	98
2. Durable consumer goods (11 products)	90
Category III (31 products)	
Current consumer manufactures	328
1. Processed foods (14 products)	436
2. Others (including semi-processed products of traditional industries (17 products)	239
Over-all average (125 products)	138

Source: Santiago Macario, "Protectionism and Industrialization in Latin America." Economic Bulletin for Latin America, March, 1964, p. 75.